

The regulation of peer-to-peer lending platforms in the consumer credit market

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von

Annalena Dierks, LL.B.

Präsident/ in der Humboldt-Universität zu Berlin:

Prof. Dr.-Ing. Dr. Sabine Kunst

Dekan/ in der Juristischen Fakultät der Humboldt-Universität zu Berlin:

Prof. Dr. Martin Heger

Gutachter

Prof. Dr. Gerhard Wagner (Erstgutachter)

Prof. Dr. Lars Klöhn (Zweitgutachter)

Prof. Dr. Andreas Nelle (Vorsitzender)

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Introduction

A little anecdote on the history of crowdfunding to start with: One of the most well-known crowdfunding projects that dates back to 1885 is the funding of the Statue of Liberty in New York.¹ The statue was a diplomatic gift from the government of France to the US. The statue had been funded by the French, but American efforts to raise funds for the socket in New York were unsuccessful and ran short.² Joseph Pulitzer, who at the time owned a newspaper, The New York World (later renamed to The World), decided to start a fundraising campaign for USD 100,000. He proposed to print the name of every donor on the front page as well as personal stories that were sometimes included in the payment envelope. The campaign raised funds from more than 120,000 people, including children, businessmen, street cleaners and politicians with more than three-quarters giving less than one dollar and in total exceeding the target of USD 100,000 in less than five months.³

Traditionally banks have been the financial intermediaries that mediate between the providers and demanders of financial means.⁴ However crowdfunding and especially peer-to-peer lending has always existed among individuals since the invention of money.⁵ In its simplest form it can be defined as individuals lending money to other individuals without a bank as intermediary.

So how does a bank's business differ from peer-to-peer lending or rather does it differ at all and why does peer-to-peer lending currently experience such a momentum?

Banks' customers can be divided into two camps: people who provide money to a bank, depositors (also called investors), and people who demand money from a bank, borrowers. Depositors deposit their money with the bank and hence receive a future claim against the bank in the amount of the deposited money, with additional interest.⁶ The bank uses the deposited money for its capital reserves and in order to fund out loans to

¹ Davies, America's crowdfunding pioneer

² Ibid.

³ Ibid.

⁴ Bundesbank, Das Banken- und Finanzsystem, p. 87, sec. 4.1.

⁵ Renton, Understanding Peer to Peer Lending, p. 4; cf. Thiele, Finanzaufsicht, p. 69 who argues that money most certainly has not been invented suddenly, but that it developed slowly and continually

⁶ Bundesbank, Das Banken- und Finanzsystem, p. 87, 88, sec. 4.1., 4.2.1.

borrowers, who in turn pay interest to the bank⁷. The bank keeps part of the interest as earnings and distributes the other part to the depositors.⁸ This shows that a bank basically fulfils the actions of a modern financial intermediary which receives money from investors and distributes the money to borrowers in order to finance their loans.⁹ However with one major difference: banks' investing customers (depositors) cannot choose the purpose their money is used for, but it is at the discretion of the bank to allocate the money. Investing money with a peer-to-peer platform contrastingly allows investors to choose the cause for their investment themselves, i.e. it empowers individuals to choose what their money is used for and consequently generates a new asset class. In comparison to social lending that has existed for decades, modern peer-to-peer lending is digitised and takes place online. The whole process is much easier and safer for the investor, since the borrowers' creditworthiness is checked by a neutral institution, enabling the investors to assess the riskiness of their investment. Additionally it makes it possible for total strangers to lend from and borrow money to one another, also people they have never met before and whose identity will not be disclosed to the other party.

Traditionally people in need of financing have thus borrowed money from a bank, however peer-to-peer lending has in recent years seen a remarkable growth in popularity¹⁰. The rapid evolution of the internet has facilitated the development of online market places that may make traditional intermediaries less important for the economic interaction of market participants.¹¹ Consequently peer-to-peer lending platforms try to circumvent banks to offer borrowers an alternative and investors a new asset class. The *Economist* has predicted that new business models "free of the bad balance sheets, high costs and dreadful reputations which burden most conventional banks" will replace traditional banks and lead to a "Banking without banks".¹²

Peer-to-peer operators need to be careful to plan and operate their business in compliance with applicable laws and regulations, even if they cooperate with a non-affiliated bank that acts as lender of record, since failure to comply with applicable regulations can result

⁷ Bundesbank, Das Banken- und Finanzsystem, p. 88, sec. 4.2.1.

⁸ Ibid.

⁹ This will be explained in further detail below.

¹⁰ Hulme, Internet Based Social Lending, p. 11

¹¹ Berger/ Gleisner., Emergence of Financial Intermediaries in Electronic Markets, p. 1

¹² Economist, Banking without banks

in, among others, civil and criminal penalties, litigation expenses as well as adverse publicity and in the worst case the termination of the business. Additional difficulties arise due to different regulations across European countries. Consequently a new assessment of the legal environment needs to be made before a peer-to-peer operator can expand its business into other countries and often leads to differing setups and business models.

The subject will be regarded from the author's own experience in the peer-to-peer lending landscape and the view of a platform functioning as intermediary in Germany. The writer worked at a peer-to-peer lending company and due to her legal background assessed different European countries, regarding their potential for expansion of the platform's business and worked on the application for a license in order for a platform to conduct peer-to-peer activities directly.

The dissertation is intended to identify principal regulations that apply to peer-to-peer lending. The focus lies on the legal framework for peer-to-peer lending in Germany, i.e. which regulations such platforms have to comply with in order to operate their business model and/or which regulations are applicable to such businesses and which license requirements apply. First of all it will be explained what peer-to-peer lending is, how it evolved and how it works. The legal framework will be investigated with regards to Germany as well as European countries, namely the United Kingdom, Sweden and the Netherlands, in comparison. It will then be examined why different European countries apply different rules and whether it would be possible to harmonise such regulations for peer-to-peer lending across Europe whilst ensuring that the countries' main rationales are fulfilled.

Part I: An introduction to banking supervision and banking regulation

A. Overview of the history of banking supervision in Germany from 1931

The supervision and regulation of banks has always been a reaction to financial crises and irregularities at individual banks.¹³ Hence, the supervision and regulation of banking activities in Europe, and the extensive national supervision in Germany in particular, had its origins in the banking crisis that occurred in 1934 as a result of the world economic crisis, which had started with the crash of the New York stock exchange in 1929, the Black Friday.¹⁴

The principle of freedom of trade was predominant also in the banking sector until the beginning of the thirties.¹⁵ Bankers nevertheless accepted the “golden banking rule” (*Goldene Bankregel*), i.e. to keep a minimum of ten percent of all debt capital as equity capital, even if most banks had fallen below that threshold already before the beginning of the world economic crisis.¹⁶ The world economic crisis (1929-1932) led to the introduction of various specific rules that restricted the freedom of trade in favour of the economic interest and the protection of investors.¹⁷

In the course of the crisis the German President declared a stop of payment transactions, a bank holiday, and following enacted various emergency decrees¹⁸, which were supposed to strengthen and stabilise the financial sector that was dominated by a run on German banks (*Banken und Sparkassen*) and the decreasing trust of investors¹⁹. The emergency decrees subsequently laid the foundation of a unified national banking supervision which was codified in the German banking law (*Reichsgesetz über das Kreditwesen* (*Reichs-Kreditwesengesetz*) – “KWG”) of December 5th, 1934.²⁰ It introduced the empire’s bank (*Reichsbank*) as supervisory authority and some general

¹³ Ehlers/Fehling/Pünder/Ohler, par. 32, Rn. 1

¹⁴ Bafin, Bankenaufsicht, sec. Geschichte der Bankenaufsicht

¹⁵ Ibid.

¹⁶ Kopper, Entwicklungspfade der Eigenkapitalregulierung von Banken, p. 1

¹⁷ Ehlers/Fehling/Pünder/Ohler, par. 32, Rn. 1

¹⁸ Among others: emergency decree served as the foundation of a unified national banking supervision (*Verordnung über Aktienrecht, Bankenaufsicht und über Steueramnestie v. 19.9.1931*), RGBL. I, S.493

¹⁹ Bafin, Bankenaufsicht, sec. Geschichte der Bankenaufsicht

²⁰ Ibid., Georg, Die Entstehung des Kreditwesengesetzes von 1961, p. 17

principles that have prevailed until now, which include inter alia, the requirement of a statutory permission for banks, principles of liquidity management, requirements for equity capital and reporting requirements for banks.²¹

The subsequent growing importance of the banking business, resulted in several revisions of the KWG.²² The first changes primarily altered the supervision of banks, first as a consequence of the *Reichsbank* losing its independence in 1939 and following in 1944 due to the dissolution of the current supervisory body²³. After the end of the Second World War, the western military governments decentralised the banking supervision in the western zones of occupation and transferred them to the different federal states.²⁴

Following the end of the war all laws remained in force and the KWG served as the basis for the bank supervision of the Federal Republic of Germany.²⁵ However the intention to extensively amend the KWG to reflect political, economic and ethical changes crystallised.²⁶ The revised KWG of July 10th, 1961 entered into force on January 1st, 1962 and created a centralised banking supervisory authority on the basis of Art. 87 par. 3 GG, the Federal Banking Supervisory Office (*Bundesaufsichtsamt für Kreditwesen*).²⁷ Since then the KWG has subsequently been amended several times (*Novellen*) in order to reflect the developments on the national and international financial markets²⁸, which due to the internationalisation of banking gradually required international agreements.²⁹ While the first amendment only led to smaller changes, the following two amendments (1976 and 1985) extended and refined the supervision of banks, which resulted in an expansion of the supervision also to other forms of financial and banking businesses and extended powers of intervention.³⁰ The succeeding amendments, from 1990 onwards, mainly transferred European directives into German law.³¹

²¹ Bafin, Bankenaufsicht, sec. Geschichte der Bankenaufsicht; Ehlers/Fehling/Pünder/Ohler, par. 32, Rn. 2

²² Georg, Die Entstehung des Kreditwesengesetzes von 1961, p. 17

²³ Bafin, Bankenaufsicht, sec. Geschichte der Bankenaufsicht

²⁴ Ibid.

²⁵ Ehlers/Fehling/Pünder/Ohler, par. 32, Rn. 2

²⁶ Bafin, Bankenaufsicht, sec. Geschichte der Bankenaufsicht, Georg, Die Entstehung des Kreditwesengesetzes von 1961, p. 17

²⁷ Ehlers/Fehling/Pünder/Ohler, par. 32, Rn. 2; Bafin, Bankenaufsicht, sec. Geschichte der Bankenaufsicht

²⁸ Bankenaufsicht, sec. Geschichte der Bankenaufsicht

²⁹ Ehlers/Fehling/Pünder/Ohler, par. 32, Rn. 3

³⁰ Bankenaufsicht, sec. Geschichte der Bankenaufsicht

³¹ Ibid.

The law for the integrated financial supervision of 01.05.2002 created the German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – “**Bafin**”) by combining the federal supervisory offices for banking, insurances and securities.³²

The European Union has additionally worked to make cross-border activities easier for banks by avoiding multiple supervision of banks in different member states as well as harmonising the competitive environment.³³ Therefore licensing requirements have been considerably harmonised and authorizations issued in one member state are accepted across the member states (single passport).³⁴

B. Rationale for the regulation of and license requirement for banking and financial activities

The following sections aim to analyse why only banks are allowed to offer loans in Germany. The basis of the analysis will be the investigation of who and which goods are protected by this regulation and whether the same protection mechanisms need to be applied in the case of peer-to-peer lending as compared to traditional banking business.

I. Banking supervision in Germany

Banking supervision in Germany is conducted by both, Bafin and the German federal bank (*Bundesbank*) in close cooperation, since Bafin alone cannot conduct a sound and effective supervision.³⁵ Bafin and the German federal bank moreover have many touch points, especially in the field of banking, since monetary and regulatory aspects are politically intertwined.³⁶ The German federal bank is responsible for the quantitative supervision, while Bafin is responsible for the qualitative supervision.³⁷ The cooperation

³² Bundesbank und Bafin, sec. 3

³³ Ehlers/Fehling/Pünder/Ohler, par. 32, Rn. 4

³⁴ Ibid.

³⁵ Boos/Fischer/Schulte-Mattler/Lindemann, KWG, par. 7, Rn. 1; BVerfGE 14, 197, 211; NJW 1962, 1670

³⁶ Ibid., Rn. 4

³⁷ Ibid., par. 6, Rn. 5

aims to improve supervisory insights as well as the practical application and to avoid doubled work.³⁸

1. Bafin

Bafin has been established as single state supervisory authority (*Allfinanzaufsicht*), in order to supervise the entire financial market and consequently being able to better recognise economic ties and interconnections.³⁹ Bafin's general task is the individual supervision of all credit and financial institutions (sec. 6 (1) KWG). It supervises and controls banks as well as financial service providers, insurances and securities. Its primary objective is to ensure the functioning, stability and integrity of the German financial system.⁴⁰ The main goals of banking supervision, and hence the main tasks of Bafin, are set forth in sec. 6 (2) KWG as the intention to combat deficiencies in the banking system, that jeopardise the security of assets, that have been entrusted to such institutes, that hinder the performance of banking or financial business according to the rules, or that can result in severe drawbacks of the whole economy. Consequently Bafin has the responsibility to protect both, the creditors as a whole from loss of their investments and the trust in the functioning of the banking system by the general public as well as the economy as a whole, not however the individual creditor or consumer.⁴¹ However in order to ensure the protection of the individual consumer creditor, a deposit guarantee secures deposits of up to 100.000 Euro per institute.⁴²

Since Bafin acts as an independent federal superior authority (*Bundesoberbehörde*), she consequently does not have any substructure in order to support her in her work and hence closely cooperates with the German federal bank.⁴³

³⁸ Ibid., par. 7, Rn. 14

³⁹ Ehlers/Fehling/Pünder/Ohler, par. 32, Rn. 27: Through the introduction of the law on the supervisory authority (Gesetz über die Bundesanstalt für Finanzdienstleistungsaufsicht (Finanzdienstleistungsaufsichtsgesetz – “**FinDAG**“)) Bafin has been established as sole supervisory authority combining several self-autonomous supervisory authorities that have existed before.

⁴⁰ Bafin, brochure: Die Bafin stellt sich vor, p. 2

⁴¹ Boos/Fischer/Schulte-Mattler/Bearbeiter, KWG, par. 6, Rn. 2, 34

⁴² Bafin, Bankenaufsicht, sec. Ziele der Bankenaufsicht

⁴³ Ehlers/Fehling/Pünder/Ohler, par. 32, Rn. 27

2. German federal bank

The German federal bank has wide knowledge in the financial sector due to its presence close to the market as well as its business connections with the credit institutions and can support the stability of the financial sector due to its longstanding experience.

It is responsible for the operative supervision and its main tasks are summarised in sec. 7 KWG and include inter alia, the receipt and evaluation of reports as well as the conduction of audits. It further regulates the cooperation with regards to the ongoing supervision by the German federal bank.⁴⁴ The German federal bank is thus responsible for the evaluation of submitted documents, such as annual financial statements and auditor's reports and responsible for the examination and supervision of capital and liquidity thresholds and requirements as well as risk management process requirements.⁴⁵

Due to its support in the operative supervision, the German federal bank receives deep insights in the financial institutions' structures and business and hence the liquidity of the markets.⁴⁶ This knowledge does not only supports the supervisory state of knowledge of the German federal bank, but also builds an important basis for the monetary decisions within the Euro system, in which it takes part together with other national central banks.⁴⁷

II. Regulation and supervision of financial markets

Banking supervision is necessary in order to provide a stable and functioning financial system, which needs to be protected from abuse and reputational risks that undermine its core functions⁴⁸. The financial system is necessary to uphold the productivity of the economy as a whole by providing financial means as well as the cost-effective transformation of financial means⁴⁹ and hence justifies the system being subject to special regulations⁵⁰. Consequently, the regulation of financial markets mainly aims to fulfil three

⁴⁴ Boos/Fischer/Schulte-Mattler/Bearbeiter, KWG, par. 6, Rn. 17

⁴⁵ Ibid., Rn. 19, 20, Bafin, Bankenaufsicht, sec. Aufgabenteilung zwischen Bafin und Deutsche Bundesbank

⁴⁶ Ehlers/Fehling/Pünder/Ohler, par. 32, Rn. 29

⁴⁷ Ibid.

⁴⁸ <http://www.worldbank.org/en/topic/financialmarketintegrity/overview#1>

⁴⁹ Bafin, Bankenaufsicht, sec. Bankenaufsicht in Deutschland

⁵⁰ Riksbank, The Swedish Financial Market, p. 12

objectives: the protection of investors, functional protection and the protection of the stability of the whole financial system.⁵¹

1. Investor protection

One major aim of the KWG is the protection of assets that have been entrusted with an institution and hence the protection of investors, especially depositors, in the available assets.⁵² As a form of consumer protection, which takes place only in the public interest,⁵³ the protection of investors thus refers to the protection of the individual⁵⁴ and aims to prevent information asymmetries⁵⁵. Investors need to be protected from misinformation, which may encourage them to invest in unsuitable products as well as misuse of their funds.⁵⁶ Financial institutions therefore have to comply with conduct of business rules, transparency regulations and information requirements, thus enabling the individual investors to assess the risks of products and the functional connections.⁵⁷ It aims to ensure that the investors as participants in the financial market do not take too high risks⁵⁸ and do not lose their deposits, since this could lead to grave economic effects. Additionally, according to the Federal Constitutional Court (*Bundesverfassungsgericht*), banking supervision is supposed to handle the risks, that can result from irregular activities of supervised businesses and hence can strengthen the investors' trust in these businesses' soundness and integrity as a framework for a flawless and working financial market.⁵⁹

2. Protection of the functionality of the financial market

The protection of the functionality (*Funktionsfähigkeit*) of the financial market is essential for economic development as well as good governance⁶⁰, because it builds the basis for market participants' trust in the system.⁶¹ Functional disorder can lead not only to a loss of property and returns but can lead to losses that can halt the development of

⁵¹ MüKoBGB/Bd. 11/Lehmann, Rn. 1

⁵² Ehlers/Fehling/Pünder/Bearbeiter, par. 32, Rn. 13

⁵³ Ibid.

⁵⁴ MüKoBGB/Bd. 11/Lehmann, Rn. 1

⁵⁵ Thiele, Finanzaufsicht, p. 99

⁵⁶ Pilbeam, Finance and Financial Markets, p. 14

⁵⁷ MüKoBGB/Bd. 11/Lehmann, Rn. 1

⁵⁸ Ibid.

⁵⁹ Ehlers/Fehling/Pünder/Bearbeiter, par. 32, Rn. 14; cf. BVerfGE 124, 235 (245) – Bafin Umlage; BGH 23.11.2010, VI ZR 245/09, Rn. 19

⁶⁰ <http://www.worldbank.org/en/topic/financialmarketintegrity/overview#1>

⁶¹ Ehlers/Fehling/Pünder/Bearbeiter, par. 32, Rn. 19

society or in the worst case set it back.⁶² Consequently supervision is a possibility to influence the development of the financial sector as a whole and to ensure the functioning of the financial economy as a whole.⁶³

The supervisory body needs to observe different elements, like technical security and quality, legal feasibility of financial activities and especially the integrity as well as reliability of such services.⁶⁴ The protection of the functionality of the financial market hence covers three different horizons: First, the institutional functionality, which refers to the market as a whole and which is crucial for economic growth and prosperity in an economy;⁶⁵ second, the operational functionality, which refers to the operational capabilities of the market with regards to individual operations;⁶⁶ and third, the allocative functionality, which refers to the capability of the market to allocate capital so that it is used in the most efficient way and the allocation of risks in an economically practical way as well as the improvement of the allocation of risks through the possibility to draw up diversified portfolios with low transaction costs.⁶⁷ Additionally the allocative capability creates the possibility to determine the market value of financial instruments at any given time.⁶⁸

3. Protection of the stability of the financial system

The protection of the stability of the financial system has always been of great importance and results from the economic functions carried out by various financial institutions, especially banks.⁶⁹ It has moved to the centre of the legislative's importance due to the world economic crisis⁷⁰, which has shown the drastic social as well as overall economic disturbances that can occur due to the lack of these functions.⁷¹ In contrast to the protection of the integrity of the financial market, which focuses on the protection of individual institutions, the protection of the stability of the financial system follows a

⁶² Thiele, *Finanzaufsicht*, p. 91: The result can be destabilisation of the political system and revolution as seen in Greece 2010/2011.

⁶³ *Ibid.*, p. 92

⁶⁴ Ehlers/Fehling/Pünder/Bearbeiter, par. 32, Rn. 19

⁶⁵ *MüKoBGB/Bd. 11/Lehmann*, Rn. 3

⁶⁶ *Ibid.*

⁶⁷ *Ibid.*

⁶⁸ *Ibid.*

⁶⁹ Ehlers/Fehling/Pünder/Bearbeiter, par. 32, Rn. 16

⁷⁰ *MüKoBGB/Bd. 11/Lehmann*, Rn. 4

⁷¹ Ehlers/Fehling/Pünder/Bearbeiter, par. 32, Rn. 16

macroeconomic approach and focuses on the risk of the collapse of the financial system as a whole.⁷² Such a collapse can occur due to the possibility of domino effects, i.e. risks for the business of one institution spreading to other institutions, which can result from contagion, i.e. the spread of the consequences of one institution's insolvency to other linked institutions, or common shocks, i.e. shocks of several institutions at the same time.⁷³ This consequently results in a loss of trust among the institutions due to information asymmetries in relation to non-transparent connections and traded products and subsequently can lead to a credit crunch, i.e. institutions not lending money to one another anymore, and/or a bank panic, i.e. a run on banks not only at one institution but at several.⁷⁴ Thus the insolvency of one institution does not only lead to its collapse, but will lead to losses among a multitude of institutions⁷⁵ which would have non-foreseeable negative effects on the financial system as whole. Consequently it is the supervisory body's task to identify and keep such systemic risks from arising.

Additionally banking supervision aims to preventively counter money laundering as well as terrorist financing.⁷⁶

The objectives for financial regulation and supervision are interdependent and hence need to be pursued together in order to ensure a stable financial system.

C. Regulation of the banking system within the European Union

The banking system is primarily regulated on the basis of the so-called Basel regulatory framework, a series of international agreements drafted by the Basel Committee on Banking Supervision, called Basel accords. The framework itself is not legally binding, but the members, representatives of the central banks and supervisory authorities,⁷⁷ have agreed to implement the regulations in their national legislation.⁷⁸ The Basel framework

⁷² MüKoBGB/Bd. 11/Lehmann, Rn. 4, see also Thiele, Finanzaufsicht, p. 85

⁷³ Ibid., both so called systemic risks, which are typical risks in that area

⁷⁴ Thiele, Finanzaufsicht, p. 86

⁷⁵ Ibid., as Thiele argues, this can already happen as a consequence of the potential insolvency of an institution due to rumors of its insolvency.

⁷⁶ Ehlers/Fehling/Pünder/Bearbeiter, par. 32, Rn. 19

⁷⁷ Initially the Basel Committee for Banking Supervision comprised the G10 member states (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States and Luxembourg (cf. Basel I, p.1, Fn. 1)); the Committee extended its membership in 2009 and 2014 and now includes 28 jurisdictions (cf. BIS, History of the Basel Committee)

⁷⁸ Economist, One Basel leads to another

has its origin in the failure of the German Herstatt Bank in 1974, which circumvented limits for foreign exchange trading and used tricks to cover up losses.⁷⁹ It highlighted the need for more international cooperation among banking regulators and led to the establishment of the Basel Committee and hence the publication of the first Basel Capital Accord.

The first accord, Basel I, was signed in 1988 and has since then been revised on two occasions: in 2004 by the Basel II accord, which has been transferred into European law through the Capital Requirement Directives (2006/48/EC and 2006/49/EC) (CRD) and in 2010/2011 by the Basel III accord, which entered into force in 2014 as a result of the global financial crisis from 2007 till 2009 and which has been transferred into European law through the Capital Requirements Directive (Directive 2013/36/EC) (CRD-IV).

Basel I focused on credit risk and appropriate risk-weighting of assets. Bank's assets were classified and grouped into categories according to their credit risk and then weighted accordingly with 0, 10, 20, 50 or 100%.⁸⁰ Additionally a minimum capital requirement of 8% of the bank's risk-weighted assets was introduced,⁸¹ i.e. a bank which had a minimum capital of 8 Million could only lend out 100 Million until its limit was reached. Furthermore capital shall be defined in two tiers, as core capital and supplementary capital. Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. It includes core capital (equity capital) as well as disclosed reserves (or retained earnings).⁸² Tier 1 capital needs to comprise 50% of a bank's capital base.⁸³ Tier 2 capital represents supplementary capital, such as undisclosed reserves, hybrid (debt/equity) capital instruments and subordinated debt.⁸⁴ Tier 2 capital is limited to 100% of Tier 1 capital.⁸⁵

Basel II was introduced in order to ensure that capital allocation is more risk sensitive. It is based on three pillars: minimum capital requirements, supervisory review and market discipline. The first pillar concerns the calculation of minimum capital requirements for

⁷⁹ FAZ, Herstatt-Bank

⁸⁰ Basel I, p. 8

⁸¹ Basel I, p. 14

⁸² Basel I, p. 3

⁸³ Basel I, p. 4

⁸⁴ Basel I, p. 4, 5

⁸⁵ Basel I, p.4

three major risks that a bank faces: credit risk, operational risk and market risk. Credit risk is defined as the risk that a counterparty will be unable to satisfy its obligations and undertakings in respect of the bank, leading to a credit loss. Operational risk is defined as the risk of loss as a result of inadequate or failed internal processes, human error, defective systems or external events.⁸⁶ Market risk is defined as the risk of loss or diminished future earnings as a result of movements in financial markets, such as changes in interest rates, exchange rates, equity prices, credit spreads, etc.

The capital ratio, also called capital adequacy ratio, is the ratio of a bank's capital to its risk and calculated as the sum of tier 1 and tier 2 capital divided by the risk-weighted assets which must be equal or greater than 8%⁸⁷ ($\frac{\text{Tier 1} + \text{Tier 2}}{\text{risk-weighted assets}} \geq 8\%$).

Banks can choose between two methodologies for the calculation of their capital requirement for credit risk. The simpler method, the Standardised Approach is intended for smaller banks with less sophisticated risk-modelling and risk-management systems and requires banks to use the risk assessment accredited by external credit rating agencies, in order to establish the risk weights.⁸⁸ The alternative methodology, the Internal Ratings-Based Approach is subject to the explicit supervisory approval of a bank.⁸⁹ It allows banks to calculate risk weights on the basis of their own internal estimates and historical data.⁹⁰ Furthermore capital needs to be provided against operational and market risk. Operational risks can be calculated according to three different methodologies according to a bank's sophistication, the Basic Indicator Approach, the Standardised Approach or the Advanced Measurement Approach and will not be allowed to revert to a simpler approach once it has been approved for a more advanced approach without supervisory approval.⁹¹ Market risk is calculated using the value at risk (VaR) approach.

The second pillar, the Supervisory Review Process, introduces tools for regulatory supervision as well as four key principles of supervisory review, risk management

⁸⁶ Cf. Basel II, p. 140

⁸⁷ Basel II, p. 12

⁸⁸ Basel II, p. 15

⁸⁹ Basel II, p. 15, 48

⁹⁰ Basel II, p.48

⁹¹ Basel II, p. 140

guidance and supervisory transparency as well as accountability.⁹² As a result the Internal Capital Adequacy Assessment Process (ICAAP) has been established.

The third pillar, market discipline, shall complement the first two pillars through the introduction of disclosure requirements in order to allow market participants to assess the capital adequacy of an institution.⁹³

Basel III has been introduced as a result of the global financial crisis and comprises reform measures to strengthen the regulation and supervision of the banking sector as well as strengthen banks' transparency and disclosures and improve their risk management and governance.⁹⁴ It includes, in particular, a review of minimum capital requirements and buffers, introduced in Basel II, an enhancement of risk coverage standards as well as the introduction of a global liquidity standard.⁹⁵ This includes principles for liquidity management as well as its supervision and new minimum requirements for risk horizons for funding liquidity.⁹⁶ The Liquidity Coverage Ratio (LCR) requires banks to have sufficient high-quality liquid assets to withstand a 30-day stress scenario, i.e. promoting short-term resilience of a bank's liquidity risk profile.⁹⁷ The Net Stable Funding Ratio (NSFR) on the other hand is designed to address liquidity-mismatches long-term over one year, covering the entire balance sheet, by creating incentives for banks to use stable sources of funding.⁹⁸

⁹² Basel II, p. 162 ff.

⁹³ Basel II, p. 184 ff.

⁹⁴ Basel III

⁹⁵ Basel III

⁹⁶ Basel III, p. 9

⁹⁷ Basel III, p. 9

⁹⁸ Basel III, p. 10

Part II: Peer-to-peer lending in the consumer credit market

A. Definitions

I. Intermediation

Intermediation connects demanders and providers of information, money or other goods.⁹⁹ It occurs due to the imperfect nature of markets and everyday situations, since complete knowledge about the market, counterparties, goods, etc. is not available.¹⁰⁰

An intermediary, also called middleman, is a company or person, such as a broker or consultant, who acts as a link between two or more parties to a deal, be it a business deal, investment decision or else.¹⁰¹

Financial intermediation is the process of transferring sums of money from economic agents with surplus funds to those who need to acquire funds.¹⁰²

II. Crowdfunding

The term crowdfunding is used both to describe donation- and reward-based funding as well as a generic term, comprising crowdinvesting and crowdlending.

- **Donation-based crowdfunding** is the intrinsic support of a project without consideration in return,¹⁰³ i.e. people donate money for a particular project within a certain time frame without receiving consideration in return.
- **Reward-based crowdfunding** on the other hand means the participation in a product or project against consideration, even if the consideration does not match the participation,¹⁰⁴ i.e. the donors may receive a symbolic, non-monetary consideration, such as inclusion of their name in the closing remarks of a film.

⁹⁹ Intermediation: <http://www.businessdictionary.com/definition/intermediation.html>

¹⁰⁰ Cf. Part I, A. II. And B. II. below for more information.

¹⁰¹ Intermediary: <http://www.businessdictionary.com/definition/intermediary.html>

¹⁰² Pilbeam, Finance and Financial Markets, p. 27

¹⁰³ Beck, Crowdinvesting, p. 25, 28

¹⁰⁴ Ibid., p. 25, 26, 28

- **Crowdinvesting** describes equity-based financing, resulting in a participation in the respective company.¹⁰⁵ The investor either receives stakes in the company or otherwise participates in the share of profits and increase in value of the company.
- **Crowdlending** describes lending-based financing, which does not result in an investor's participation.¹⁰⁶ The investor rather receives a repayment claim, including interest, while the borrower, being either a private individual or an enterprise, receives a loan and has to repay the respective loan amount plus interest. In the case of the borrower being a private individual, this form of lending is also often called person-to-person or peer-to-peer lending.

III. Peer-to-peer lending

Peer-to-peer lending, often also abbreviated as P2P lending, or called person-to-person lending or simply social lending, is a process enabling individuals to lend money to other individuals without a bank as intermediary.¹⁰⁷ It is a method of debt financing that enables individuals to borrow and lend money, without the use of a financial institution as intermediary¹⁰⁸ and hence removes the middleman, the financial intermediary, from the process of lending¹⁰⁹.

The term peer-to-peer lending is used very widely and often differs depending on regions, maximum loan amount, target group etc. In order to avoid any misunderstanding the following definition will be followed: "[...] in which individual consumers borrow from, and lend money to one another by means of unsecured personal loans up to \$ 25,000, without the mediation of a financial institution"¹¹⁰.

Additionally the self-descriptions of peer-to-peer lending platforms sharpen the picture of peer-to-peer lending models. Prosper and Lendico for example describe themselves as

¹⁰⁵ Ibid., p. 25, 28; examples include Companisto and Seedmatch

¹⁰⁶ Ibid. p. 25, 28; examples include US based Lending Club and German based Lendico and auxmoney

¹⁰⁷ Renton, Understanding Peer to Peer Lending, p. 4

¹⁰⁸ Peer-To-Peer Lending (P2P): <http://www.investopedia.com/terms/p/peer-to-peer-lending.asp>

¹⁰⁹ Ibid.

¹¹⁰ Herzenstein/Andrews/Dholakia/Lyandres, The Democratization of Personal Consumer Loans, p.3

financial, peer-to-peer lending or credit “marketplace”¹¹¹. Lendico and Lending Club likewise portray their companies as connecting borrowers and investors¹¹² and thus emphasize the aspect of connection between the right individuals. Zopa contrastingly describes itself as “peer-to-peer lending service”¹¹³.

The typical loan, characteristically for peer-to-peer lending platforms, is an unsecured personal loan between EUR 1,000 and EUR 30,000.¹¹⁴ Unsecured loans are loans where a collateral is not required and borrowers are not asked to pledge assets to the lender as security for the loan.

IV. Consumer credit

A consumer credit is a personal loan that is extended by a business as creditor to a consumer as borrower.¹¹⁵ It is a short-term loan for the purpose of purchasing goods or services.¹¹⁶

B. Historical background

Under traditional neoclassical assumptions markets are complete and perfect, allocation of resources are efficient and intermediaries are not needed.¹¹⁷ A perfect market is a market in which buyers and sellers have complete information about a product and it is easy to compare prices and other information, because they are the same. It is a market, based on complete transparency and information symmetry, in which no personal, temporal or factual preferences exist between market participants, adaptations happen with extremely high reaction rates and the maximisation of the individual gain and benefit is the most important imperative.¹¹⁸

¹¹¹ Lendico: <https://www.lendico.de/>; Prosper, About us: <https://www.prosper.com/plp/about/>

¹¹² Lendico, Über uns

¹¹³ Zopa, About Zopa, <https://www.zopa.com/about>

¹¹⁴ The loan amounts differ between the different peer-to-peer platforms and sometimes change. As of 21.06.2016 the maximum loan amounts were as follows: Lendico €30,000; LendingClub \$40,000; Prosper \$35,000; Zopa £25,000,

¹¹⁵ Cf. par. 491 (1) BGB

¹¹⁶ Consumer Credit: <http://www.investopedia.com/terms/c/consumercredit.asp>

¹¹⁷ Allen/Santomero, The theory of financial intermediation, p. 5; cf. Arrow-Debreu model of resource allocation: Arrow/Debreu, Equilibrium for a Competitive Economy, p. 265

¹¹⁸ Faßbender, P2P Kreditmarktplätze, p. 43

Applied to financial markets this consequently would mean, that borrowers and lenders do not face any frictions of transaction costs, nor asymmetry of information and thus are able to share capital free of charge and through secure transactions without a third party, i.e. an intermediary, being needed. However, in reality, the financial market is far from being considered a perfect and complete market. The presence of market imperfections has rather shown the need and importance of intermediaries,¹¹⁹ in order to reach a balanced financial market.

Traditional financial institutions such as banks, credit unions and alternative financial service provider have always acted as intermediaries in the allocation of goods and lending money and the old idea of personal credits has a longstanding informal practice among family and friends. Leveraging the emergence of the internet two slightly different lending models sharing the same fundamental concept have developed. The first model, a form of direct peer-to-peer lending, pioneered in 2001 under the name of CircleLending, later and better known as Virgin Money US. They used the idea of personal credits by streamlining and professionalising the process of loan issuance between parties who already had an existing relationship and already had agreed to lend money from and borrow money to one another.¹²⁰ The basic principle of Virgin Money US was hence to facilitate and administer the loan origination and repayment process for family members and/or friends.¹²¹ Another lending model, which has become known as peer-to-peer lending, was founded by Zopa in the United Kingdom in 2005.¹²² This model has given unaffiliated individuals the opportunity to connect in order to borrow money from and lend money to each other without having an existing relationship.¹²³

Since then numerous other peer-to-peer marketplaces, like US-based Lending Club and Prosper, Funding Circle (UK), Pret d'Union (France), Auxmoney and Lendico (Germany),¹²⁴ have been founded around the world. Due to different regulatory environments, not only across Europe, but globally, their business models differ considerably. Even though every peer-to-peer lending platform aims to directly

¹¹⁹ Allen/Santomero, *The theory of financial intermediation*, p. 6

¹²⁰ Renton, *The Demise of Virgin Money US*

¹²¹ Ibid.

¹²² Zopa, *About Zopa*, <http://www.zopa.com/about>: Zopa claims to be the UK's leading peer-to-peer lending service.

¹²³ Zopa, *How peer-to-peer lending works*, <http://www.zopa.com/peer-to-peer-lending>

¹²⁴ The countries refer to country of origin, not countries where the platform is operating.

circumvent banks acting as the intermediary, this aim can sometimes not be pursued as strictly due to regulatory restrictions, so that some peer-to-peer operators partner up with banks in the background in order to comply with laws and regulations, especially with regards to the issuance of loans.¹²⁵

C. General principles of peer-to-peer lending

I. Overview

A platform operator offers a platform, for borrowers and investors to get in contact with each other. The senders and recipients of information are mainly the borrowers and investors, the platform functions as an intermediary between the two parties. Borrowers register on the platform and submit an application for a loan. The creditworthiness and the identification of the borrowers will be checked against the information from external third parties (inter alia, credit bureau and identification service provider) and, if approved, the loans will be placed on the website for investors to fund. No personal information will be displayed on the website, but certain information with regards to the conducted risk assessment as well as information with regards to the loan, such as loan amount, term of the loan and purpose, will be provided to the investors. The investors can then fund the loans for a predefined period of time.

The forms of bidding can differ between peer-to-peer lending models. Generally one differentiates between an auction method and a pricing method. The auction method is based on borrowers posting the maximum interest rate they are willing to accept. Investors then bid by decreasing the interest rate until it strikes the lowest a lender would accept.¹²⁶ The pricing model follows a different approach, where the interest rate a borrower has to pay is determined by the peer-to-peer platform based on a risk assessment. Investors hence do not have any influence on the interest rates and only bid until the loan is fully funded.¹²⁷

¹²⁵ See section B. I. below for more detail.

¹²⁶ Chen/Ghosh/Lambert: Auctions for Social Lending: A Theoretical Analysis, p.1,2: The auction method was used by Prosper from 2005 until 2010 and Prosper described itself as “ebay for loans”.

¹²⁷ Cf. Lendico AGB, <https://www.lendico.de/agbs-33.html>

Peer-to-peer platforms make money by charging either a flat fee or percentage interest rate from both borrowers, so called Borrower Fee, and lenders, so called Investor Fee.¹²⁸ Borrower fees are often higher, since more services are related to them as users of the platform. Peer-to-peer lending platform's costs thereby are usually lower than those of traditional credit institutions.¹²⁹

The subsequent process depends on whether the peer-to-peer platform itself issues the credit to the borrower (direct peer-to-peer lending) or whether a partner bank functions as lender of record (indirect peer-to-peer lending).

1. Direct peer-to-peer lending

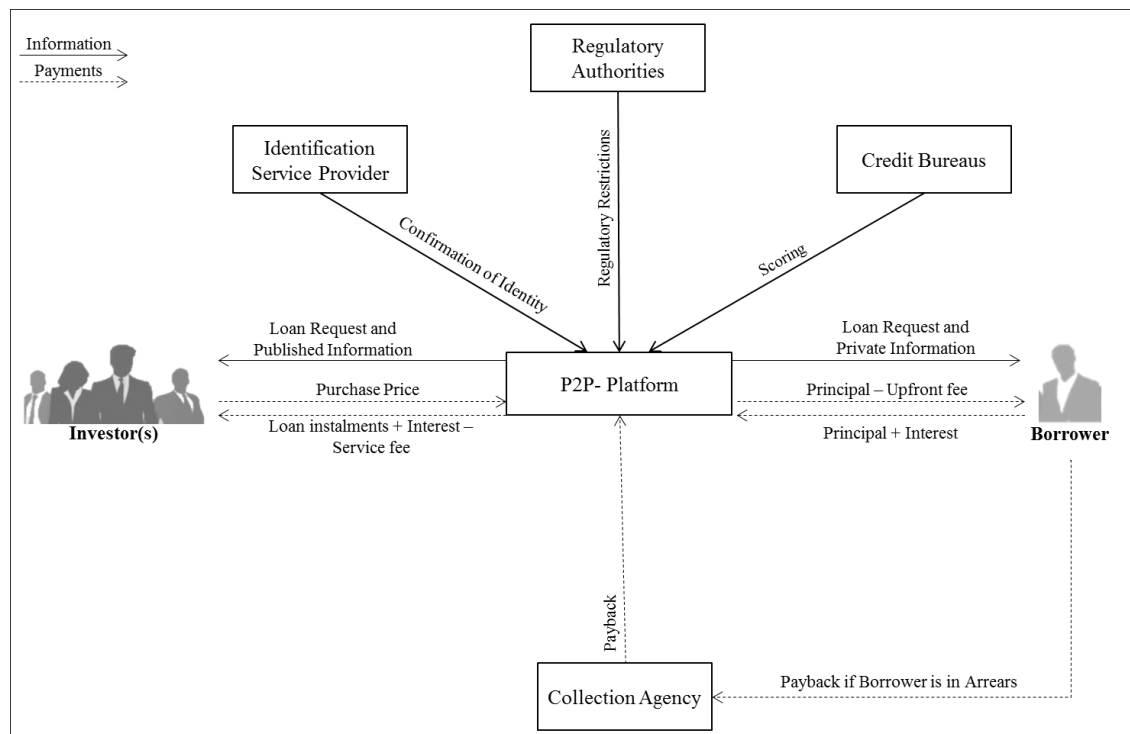


Figure 1¹³⁰

In the case of direct peer-to-peer lending, the platform will enter into a loan agreement with the borrower once a loan has been completely funded and into sale and transfer agreements with the investors corresponding to their commitment in the loan. The

¹²⁸ Cf. Lendico, <https://www.lendico.de>

¹²⁹ Renner, "Banking Without Banks"?, p.263

¹³⁰ Own figure based on Faßbender, P2P Kreditmarktplätze, p. 51

platform will handle all payments between investors and borrowers. The collection agency will only step in, if the borrower defaults on the repayments.

This form of peer-to-peer lending is not very popular in Germany, because as will be explained below only banks are allowed to issue loans in Germany. But European peer-to-peer platforms, like inter alia, Zopa and Lendico Netherlands, operate under that model.

2. Indirect peer-to-peer lending

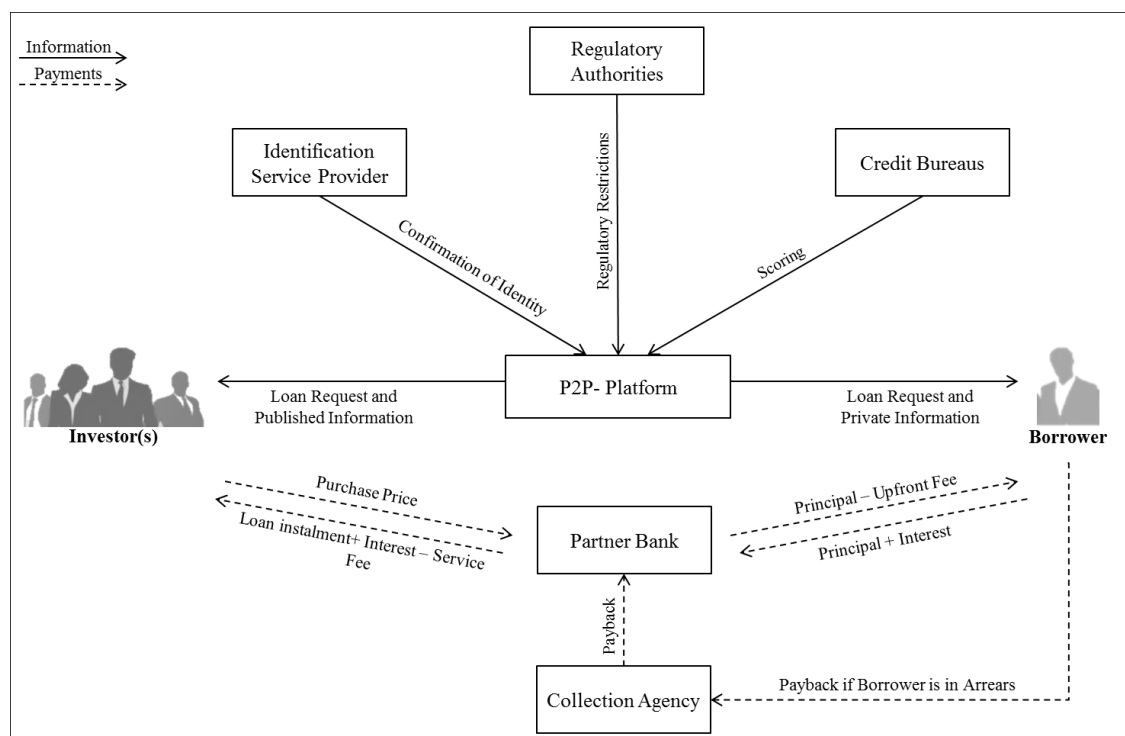


Figure 2¹³¹

In contrast, indirect peer-to-peer lending involves another party, a partner bank. The peer-to-peer intermediary merely offers a platform for borrowers and investors to connect. Agreements are entered into between the partner bank and the borrower and the partner bank and the investor(s). On the one hand, the partner bank enters into a consumer loan agreement with the borrower, while the platform operator acts as intermediary to the conclusion of the loan contract. On the other hand the partner bank enters into a

¹³¹ Own figure based on Faßbender, P2P Kreditmarktplätze, p. 51

receivables purchase agreement with the investor(s),¹³² however usually a company associated with the platform operator will be involved.¹³³

The involvement of an associated entity has been chosen due to the nature of peer-to-peer lending, which involves multiple investors. If the bank entered into the receivables purchase agreements with each of the investors that are involved in one loan, it would be subject to multiple transactions and claims. However by involving an entity associated with the peer-to-peer platform, this entity can act as service provider for both the bank and the investors. The bank enters into a sale and transfer agreement with the associated entity, which in turn enters into sale and transfer agreements with all of the investors. The associated entity consequently administers the contracts. However the bank will receive payment details from the investors from the associated entity and transfer the loan instalments received from the borrower directly on to the respective investors (less the service fee).

This form of peer-to-peer lending is very popular among German peer-to-peer lending platforms, like Auxmoney and Lendico Deutschland.

II. Interim result

Due to different legal requirements and settings peer-to-peer lending models differ internationally. As will be explained in further detail below, Germany mainly follows the indirect peer-to-peer lending model, i.e. the peer-to-peer platform merely acts as intermediary, while a partner bank enters into a credit agreement with the borrower.

D. Financial functions performed by intermediaries

Financial intermediaries perform different functions in order to ensure proper allocation of goods and resources.¹³⁴ The following section will describe the financial functions performed by intermediaries and contrast the intermediary functions performed by traditional financial intermediaries and peer-to-peer lending platforms. It will further be

¹³² Cf. Auxmoney

¹³³ Renner, *Banking Without Banks*, p.264; cf. also the terms and conditions for private investors

¹³⁴ Cf. Part I, A. II. above

scrutinised whether the execution of these functions through intermediaries is more efficient compared to the direct execution of the original market participants, thus confirming the need and existence of financial intermediaries. The most important function of a financial intermediary, whether a traditional or a peer-to-peer lending platform, is the assistance in the transfer of funds from surplus agents to deficit agents.¹³⁵ Through the assistance in this process a financial intermediary also undertakes several other economic functions, such as payment functions, information, lot-size, maturity and risk transformation as well reduction of transaction costs, which will be investigated in more detail below.

I. Traditional financial intermediation

First an overview will be given of the financial functions performed by traditional intermediaries, such as banks. They actually fulfil one of the prerequisites for economic prosperity, since they do not simply keep capital surpluses, but transfer these surpluses to the users of capital¹³⁶ as such enabling larger investments, which otherwise would not be possible to finance. Consequently the principal function of these institutions is the transfer of capital from people or businesses with a capital surplus, so called capital providers or investors, to people or businesses with a capital deficit, so called capital demanders or borrowers.

1. Payment function

In most industrialised countries, the majority of payments does not involve the direct exchange of cash between agents anymore.¹³⁷ Consequently one of the main functions performed by intermediaries is the provision of payment mechanisms and hence liquidity.¹³⁸ Intermediaries thus operate payment systems, in order to transfer payments from a payer to a payee, reducing the associated risks and costs¹³⁹.

¹³⁵ Pilbeam, Finance and Financial Markets, p.30

¹³⁶ Thiele, Finanzaufsicht, p. 109

¹³⁷ Pilbeam, Finance and Financial Markets, p. 30

¹³⁸ Thiele, Finanzaufsicht, p. 109

¹³⁹ Faßbender, P2P Kreditmarktplätze, p. 46

2. Information transformation and reduction of transaction costs

Additionally information asymmetries exist between the parties which can lead to distrust among them and which ultimately results in capital providers not being able to estimate the risks associated with a specific capital demander or investment.¹⁴⁰ Therefore providing a sufficient level of verified information and comparisons on various investment possibilities is an important part of the information function performed by intermediaries.¹⁴¹ With this information present it is assumed that both capital providers and capital demanders have an improved position in order to make a decision.

In order to exchange capital it is incumbent for capital providers and capital demanders to know one another and to have matching interests. Without the existence of intermediaries transaction costs, to find one another are relatively high.¹⁴² Intermediaries reduce these costs by improving resource allocation through connecting matching capital providers and demanders and aligning and fulfilling all interests at the same time.¹⁴³

3. Lot-size transformation

The capital amount supplied by capital providers rarely matches the amount demanded. Expectations and opportunities also often differ among the parties, resulting in non-matching amounts. In an environment without intermediaries the parties face transaction, information and search costs, in order to find a matching counterpart.¹⁴⁴ Intermediaries reduce these costs by bundling or pooling smaller amounts into larger amounts or vice versa splitting larger amounts into smaller amounts¹⁴⁵ as such enabling capital exchange through lot-size transformation.

4. Maturity transformation

Likewise the expectations in relation to the term of an investment and loan can differ between the parties. Investors usually wish to have their funds redeemable at short notice, while borrowers typically wish to borrow funds long-term. Different possibilities are in

¹⁴⁰ Faßbender, P2P Kreditmarktplätze, p. 46

¹⁴¹ Faßbender, P2P Kreditmarktplätze, p. 47

¹⁴² Thiele, Finanzaufsicht, p. 115

¹⁴³ Ibid., p. 116

¹⁴⁴ Thiele, Finanzaufsicht, p. 115

¹⁴⁵ Thiele, Finanzaufsicht, p. 116, 117

place on how maturity and liquidity transformations can take place. Maturity transformation can be described as the process of transforming short-term liabilities, such as deposits, into medium- to long-term assets, such as loans.¹⁴⁶ The easiest approach however, is to match capital providers and demanders with equal or similar durations. Also smaller deposits can be used to finance larger loans which are then exchanged for new deposits after their maturity.¹⁴⁷ Finally, in order to create and ensure liquidity, contracts can also be traded on the secondary market even before their date of maturity.¹⁴⁸ Intermediaries thus again reduce transaction, information and search costs for both parties as they enable matching of counterparts and replacements.

5. Risk transformation

Investments and deposits always bear the risk that repayments cannot be made on time, in full or in the worst case at all. Investors and depositors usually aim to keep their risks low or compensate them with a corresponding higher return while borrowers usually search capital for risky projects and investments.¹⁴⁹ Without the existence of intermediaries both parties would face a problem, investors and depositors would not invest their money at all, since from a rational perspective they could not and would not want to take such a risk, while borrowers would not be able to raise enough capital.¹⁵⁰

In order to solve the problem investors could diversify their portfolio and risk by investing smaller amounts in various projects. However this would lead to high transaction costs and actually is not possible due to the rather small investment amounts.¹⁵¹ But intermediaries can solve these frictions through risk transformation, i.e. the transformation of low-risk deposits into bundles of risky loans or assets,¹⁵² by performing what single investors are not able to. They can either connect capital providers and demanders with corresponding risks or simply by collecting and pooling various smaller amounts to be invested together in different projects, hence decreasing the single investor's risk through diversification¹⁵³.

¹⁴⁶ Pilbeam, Finance and Financial Markets, p. 31

¹⁴⁷ Faßbender, P2P Kreditmarktplätze, p. 46

¹⁴⁸ Thiele, Finanzaufsicht, p. 119, 120

¹⁴⁹ Ibid., p. 120

¹⁵⁰ Ibid.

¹⁵¹ Ibid., cf. also Pilbeam, Finance and Financial Markets, p.31

¹⁵² Pilbeam, Finance and Financial Markets, p. 31

¹⁵³ Thiele, Finanzaufsicht, p. 121

6. Summary

Traditional financial intermediaries thus are able to reduce some of the problems associated with the imperfect nature of markets and resource allocation and it shows that the performance of these functions by intermediaries is more efficient than amongst the market participants themselves.

II. Financial intermediation in peer-to-peer lending

These principles will now be applied to peer-to-peer lending in order to investigate whether peer-to-peer lending intermediaries likewise can effectively and efficiently perform these functions vis-à-vis borrowers and investors.

1. Payment function

Peer-to-peer platforms would need to execute payments and provide liquidity. Payment executions performed by peer-to-peer platforms are basically the pay out of loans and monthly instalments. The payments are executed either by the peer-to-peer platform itself (direct peer-to-peer lending) or by the partner bank (indirect peer-to-peer lending) in which case the peer-to-peer platform merely requests the partner bank to carry out predefined payments. The fulfilment of the payment function is consequently either directly performed by the peer-to-peer lending platform itself or indirectly, upon instruction of its partner bank. Liquidity is ensured on an individual basis, through the continuous collection of investor monies for specific loan requests.

2. Information transformation and reduction of transaction costs

As described above it is incumbent for capital providers and capital demanders to know one another and to have matching interests, in order to exchange capital. Information transformation consequently is one of the key intermediary functions performed by peer-to-peer lending platforms since they create a platform which enables both parties to interact and connect.¹⁵⁴ Moreover peer-to-peer platforms reduce information asymmetries by providing investors with valuable information about the borrowers, such

¹⁵⁴ Cf. Faßbender, P2P Kreditmarktplätze, p. 54

as information gathered during the registration process as well as information received from external partners, like credit bureaus and scoring agencies. The information is then transparently shown on the website, alongside with the provision of explanations, help and statistics, thus enabling the investors to make an informed decision. As a consequence of the information transformation, information asymmetries are removed and subsequently transaction costs reduced.

3. Lot-size transformation

Lot-size transformation can occur in different ways in peer-to-peer lending. On the one hand, investors can diversify their investment and hence their portfolio by splitting their investment and investing smaller amounts in multiple loans without being required to fully fund one single loan. On the other hand, investors can make use of an investment manager that automatically invests in various loan projects based on predefined investment criteria. Lot-size transformation consequently is performed either indirectly through the peer-to-peer platform by providing an environment for investors to do so themselves or directly through introduction of an automatic investment manager.¹⁵⁵

4. Maturity transformation

The duration for borrowed and invested money correspondingly are always exactly the same due to direct investments in specific loan projects with predefined durations. Flexibility in or a change to durations currently is not possible on the German market, since yet no secondary market enabling investors to resell claims to other investors exists.

5. Risk transformation

Peer-to-peer lending platforms perform several roles in order to facilitate risk transformation. They conduct a risk assessment and classify borrowers into different risk classes, based on the credit score received from a credit bureau or scoring agency. Investors subsequently have the possibility to choose their investments themselves, based on the conducted risk assessment and can invest in different loan projects. Consequently they can diversify their portfolio and spread their risk according to their willingness to

¹⁵⁵ Cf. Faßbender, P2P Kreditmarktplätze, p. 53

take risks across different risk classes. The risk transformation hence occurs indirectly, since peer-to-peer platforms create an environment in which investors can diversify their portfolios themselves. The risk transformation performed by peer-to-peer lending platforms however moreover represents an important change in the nature of the functions performed by traditional intermediaries, since peer-to-peer lending platforms transfer the credit risk, i.e. the risk of the borrowers' default, onto the investor.

6. Summary

Peer-to-peer lending operators thus perform the same five important functions as traditional financial intermediaries, thus enabling the interaction between capital demanders and capital providers. As analysed above, peer-to-peer lending platforms perform these functions as efficiently as traditional intermediaries and hence create a viable alternative to traditional intermediaries. Additionally the performance of these functions by peer-to-peer lending operators likewise is more efficient than amongst the market participants themselves.

E. Exemplary description of peer-to-peer lending

The German peer-to-peer platform Lendico has been chosen to serve as the basis for an exemplary description of the indirect peer-to-peer lending process for consumer credits, where a partner bank functions as grantor of the loan.¹⁵⁶

The main administrative processes that are conducted have been identified as: loan issuance, investor funding, payback and collection, including several sub-processes. The figure below serves as an illustration of the parties involved, an overview of the main administrative processes and contractual relationships.¹⁵⁷

¹⁵⁶ The description is based on the company's terms and conditions accessed via their website: <https://www.lendico.de/agbs-33.html> and research on Lendico, last accessed on 18.01.2016, 1:50 pm

¹⁵⁷ Own figure based on the below description

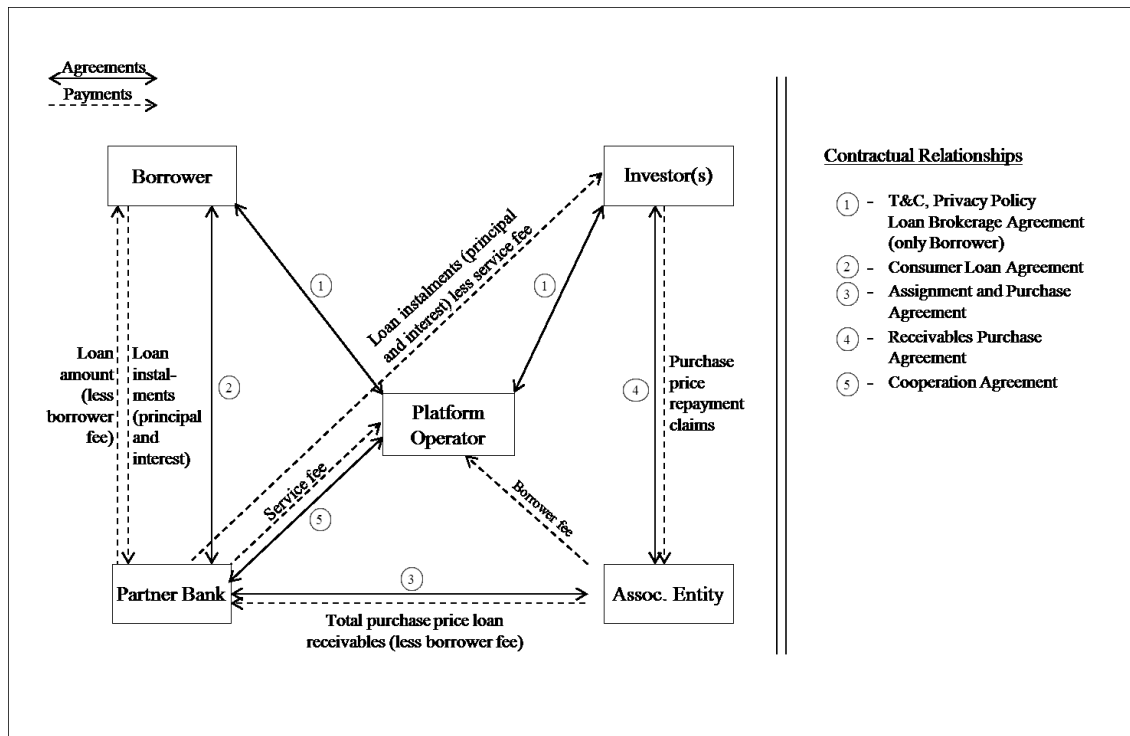


Figure 3

I. Loan issuance process

The loan issuance process is divided into four sub-processes: registration and loan application, risk evaluation and pricing, underwriting and origination.

1. Registration and loan application

A borrower registers on the platform and enters into an agreement with the peer-to-peer player (“**the platform operator**”) regarding the use of the platform, by accepting the Terms and Conditions as well as the Data Protection Policy.¹⁵⁸ During the registration process the borrower has to enter personal details such as, *inter alia*, name and address, certain employment and income details, expense details and bank account information. In addition the borrower has to give the credit project a title and determine the purpose of what it will be used for, e.g., *inter alia*, education, furniture or debt consolidation, which also needs to be described briefly. Hence the borrower needs to define the loan request details, i.e. choose a loan amount of EUR 1,000 to a maximum of EUR 30,000 and duration of six months to five years.

¹⁵⁸ Lendico, <https://www.lendico.de/konditionsanfrage/persoenliches#baseForm>

2. Risk evaluation and pricing

Based on the provided data the platform operator performs an automated credit and fraud check in order to verify the entered data and to check the borrower's identity. If the borrower passes this pre-check his/her creditworthiness is next evaluated.

The platform operator determines the borrower's creditworthiness and credit score on the basis of the SCHUFA credit score. This score is acquired by the platform operator's partner bank, due to a cooperation agreement between the SCHUFA and the bank. The SCHUFA credit score is calculated, *inter alia*, based on the amount of debt a consumer holds, history of payment, length of credit relationship and applications for new loans. The platform operator, on behalf of the bank, then calculates the borrower's creditworthiness on the basis of the SCHUFA score and the borrower's probability of default (PD). The platform operator thereby evaluates whether the borrower meets the requirements for granting a loan. Based on the credit score, the borrower is hence grouped into one of the platform operator's risk classes, from Lendico Class A as lowest risk category to Lendico Class E as highest risk category. In case the scoring fails because no data is available or the identity is invalid, the borrower will be flagged and entered into the manual review process, i.e. the loan operations team will review the entered information manually and score the borrower again if any adaptations have been made.

The interest rate (nominal and effective) will be assigned by the platform operator through a risk-based pricing approach. It consists of an underlying base rate reflecting the economy and varies for different loan durations. Additionally it takes into account the individual risk (PD and loss given default (LGD)) based on the determined risk class and the service fees for investors and borrowers.

After determining the risk class and therefrom the interest rate, the platform operator informs the borrower instantly whether his/her application has been successful and quotes the terms, i.e. the interest rate, the loan amount and duration. A borrower can then decide to accept the terms based on the loan amount requested.

If the borrower accepts the offer, the credit project will be displayed on the website for a predefined period of time (fourteen (14) days), during which investors can fund the loan with increments of EUR 25.

3. Underwriting

Once the borrower accepts the offer, the credit project is still pending and the borrower will be required to provide certain documents in order to get fully verified. The underwriting process and the manual review processes have been introduced in order to detect inconsistencies or potential fraud attempts, such as, *inter alia*, frequent movement in recent years or inconsistencies in relation to the income information. The documents required include, *inter alia*, a bank statement and a certificate of salary as well as a passport or ID copy. These documents are physically verified by the underwriting team and crosschecked against the information entered by the borrower during the application process, like full name, address, phone number, date and place of birth. Finally the borrower will be physically verified through PostIdent, an identification method performed by Deutsche Post. If the borrower passes these checks s/he will get fully verified, otherwise s/he will be rejected.

4. Origination

Simultaneously to the underwriting process, the loan is offered to investors via the platform for funding for a predefined period of time (fourteen (14) days). If the loan gets fully or partially funded, i.e. at least fifty (50) percent of the requested loan amount and more than EUR 1,000, within the set time period, a consumer loan agreement (sec. 491 (1) German Civil Code (*Bürgerliches Gesetzbuch* – “BGB”)) will be sent out to the borrower who will enter into a loan agreement with the platform operator’s partner bank which will also pay out the loan amount to the borrower.

The platform operator, functioning as intermediary, charges a brokerage fee for the mediation of the credit agreement between the bank and the borrower of 0.5% to 4.5% of the loan amount, i.e. the loan amount will be paid out to the borrower net of that service fee.

If the loan does not get fully funded, the platform operator may offer the loan to the borrower with the amount funded so far or otherwise reject it. In the latter case, all investments made so far will be cancelled and the loan will be taken off the platform.

II. Investor funding

Investors have to register on the platform and enter personal details, such as, *inter alia*, name and address as well as bank details, such as, *inter alia*, IBAN and BIC.

Hence the investors and the platform operator enter into an agreement regarding the use of the platform, by accepting the Terms and Conditions as well as the Data Protection Policy. The investors thereby create a user account, from which they can fund as many credit projects as they wish with increments of a minimum of EUR 25 with no maximum investment amount. Therefore a loan project can either be funded by only one investor or by multiple investors. If a loan gets fully funded within the set time period and the consumer loan agreement has been accepted by the borrower, the money of the investors will be collected by the platform operator on behalf of its partner bank and transferred to the bank, who will pay out the loan amount to the borrower.

The bank sells and transfers the future repayment claim to an associated entity according to sec. 433 (1), 398, 158 BGB in each case subject to the condition precedent that it receives the purchase price.

The associated entity, an entity affiliated with the platform operator, enters into an agreement with each investor participating in the relevant credit project according to sec. 433 (1), 398, 158 BGB regarding the sale and transfer of the repayment claim, i.e. the future repayment claim and interest claims under the loan, and transfers the future repayment claims to the investors on a *pro rata* basis (net of a service fee of one (1) percent per repayment), subject to the condition precedent that the loan has been extended to the borrower and the bank has transferred the repayment claim to the associated entity.

III. Payback

The payback process is divided into two sub-processes, payback by borrowers and payback to investors, due to the fact that the borrower has to repay monthly instalments under the loan agreement and the investor will receive monthly instalments for her/his investments.

1. Payback by borrowers

Under the loan agreement borrowers are required to repay the loan in fixed monthly instalments. The amount will therefore be debited from the borrowers account on a monthly basis. The payback will be monitored and the borrower will be entered into the collection process in case s/he comes into arrears.

However a borrower is under certain circumstances also entitled to change the duration of the contract. This includes the possibility to shorten the term of the contract, i.e. repay the loan early or to prolong the term of the loan contract. The borrower furthermore has the right to cancel the contract before the loan has been paid out. In that case the loan will be taken off the platform and the investor(s) will be informed thereof. Borrowers are also entitled to withdraw the loan contract within fourteen (14) days from conclusion of the contract according to sec. 355, 356b BGB. In that case the platform operator will inform the investor(s) of the withdrawal and return the funds to the respective investor(s).

2. Payback to investors

Investors will receive detailed information about the expected repayments, the timing of the repayments and other applicable information once the loan has been originated. The bank, assisted by the platform operator, will transfer the monthly instalments received from the borrower to the respective investors, net of a service fee of 1% per repayment.

Investors are however also entitled to withdraw funding within fourteen (14) days of confirming their investment, according to sec. 355, 312d BGB. In such cases the platform operator returns the funds to the investors and informs the borrower of the change of ownership.

IV. Collection

The collection process comes into effect once loans come into arrears, in case of insolvency or debt counselling, in case the customer is under custodianship (within the meaning of sec. 1896 ff. BGB), deceased or if he asks for a reduction of his instalments. The collection process is divided into two processes, the in-house process and the external process.

The platform operator conducts the collection services during the first ninety days of a borrower's default (in-house collection). This includes sending out dunning letters as well as offering refinancing strategies to help its customers, i.e. deferral or reduction of instalments through a modification of the contract (sec. 491, 145, 147 BGB).

The platform operator will hand over the collection process to an external collection agency after ninety days of the borrower's default (external collection). This includes the cancellation of the loan contract and sale of the repayment claim to a collection agency according to sec. 433 (1), 398 BGB.

V. Contractual relationships

The contractual relationships are depicted in the figure¹⁵⁹ below and then explained in more detail:

¹⁵⁹ Own figure

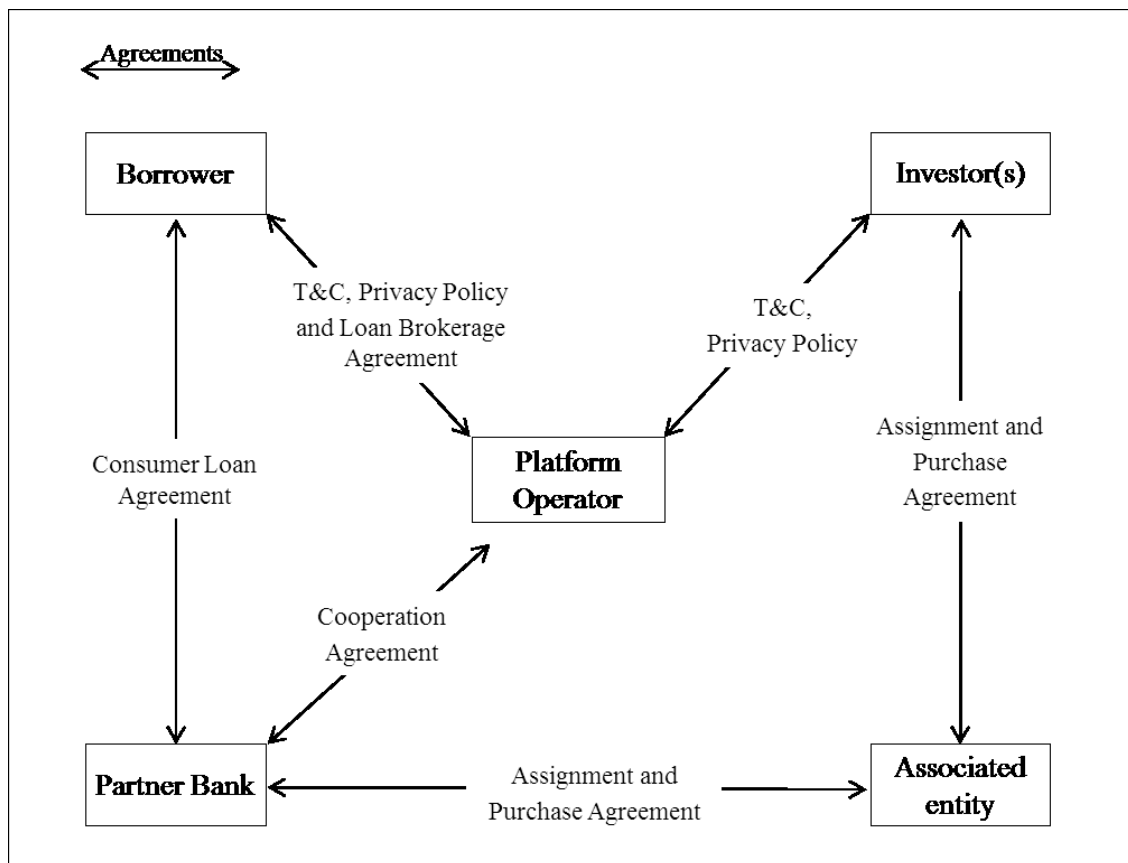


Figure 4

1. Contractual relations between the platform operator and the users

a) Terms and Conditions

Upon registration on the platform each borrower and each investor enters into an agreement with the platform operator regarding the use of the platform, by accepting the terms and conditions (*Allgemeine Geschäftsbedingungen Bedingungen (AGB)*) within the meaning of sec. 305 BGB, according to sec. 145, 147 BGB.

Terms and conditions are pre-formulated conditions that apply to a multitude of contracts and that are terms of the contract that are intended to shape the contract's subject matter¹⁶⁰. They are given out by one party to the contract (sec. 305 (1) sent. 1 BGB) so that they become part of the contract.¹⁶¹

¹⁶⁰ Palandt/Grüneberg, par. 305, Rn. 4

¹⁶¹ Palandt/Grüneberg, par. 305, Rn. 10

b) Data Privacy Policy

Each borrower and each investor furthermore has to consent to the use of personal data by the platform operator by accepting the data privacy policy (*Datenschutzerklärung*) according to sec. 145, 147 BGB.

The data privacy policy regulates which data is collected from both the borrowers and the investors, for which purpose and how it will be used.¹⁶² It furthermore describes the use of different third party items such as cookies, web analytics and marketing services such as Google Universal Analytics as well as retargeting measures, use of device ident and social plugins such as Facebook, Twitter and Google Plus.¹⁶³ In addition it describes how a user can request information regarding the saved data in relation to his/her person as well as a correction in case of erroneous saved data or the deletion of the data.¹⁶⁴ Finally it also sets out the right of revocation of the data privacy policy and how this right can be exercised.¹⁶⁵

2. Contractual relations with the borrowers

a) Consumer Loan Agreement

The partner bank enters into a consumer loan agreement (*Verbraucherkreditvertrag*) with the borrower according to sec. 491 (1) BGB. A consumer loan agreement is every loan agreement within the meaning of sec. 488 (1) BGB that is concluded between a business within the meaning of sec. 14 (1) BGB as creditor and a consumer within the meaning of sec. 13 BGB as borrower.¹⁶⁶ The bank is a company, i.e. a legal person, who concludes the contract within her commercial capacity and as such a business within the meaning of sec. 14 (1) BGB. The borrowers are natural private persons who conclude the agreement for purposes which are mainly neither in relation to a commercial, nor a professional activity and therefore as consumers within the meaning of sec. 13 BGB.

¹⁶² Lendico Datenschutzerklärung, <https://www.lendico.de/datenschutzerklaerung-32.html>, sec. 2-3

¹⁶³ Ibid., sec. 1.1-1.4

¹⁶⁴ Ibid., sec. 1.7

¹⁶⁵ Ibid., sec. 5

¹⁶⁶ Palandt/Weidenkaff, par. 491, Rn. 1, MüKoBGB/Bd. 4., Schürnbrand, sec. 492, Rn. 8

The contract is concluded through offer and acceptance according to sec. 145, 147 BGB and needs to be agreed in writing, within the meaning of sec. 126 BGB according to sec. 492 (1) sent. 1 BGB¹⁶⁷. The loan agreement is sent out to the borrower in writing via post and needs to be signed and sent back to the bank, thus fulfilling the requirements of sec. 492 (1), 126 BGB.

Under the loan contract the lender is obliged to pay out the loan to the borrower, i.e. the lender has to make the amount of money available to the borrower.¹⁶⁸ The borrower has to accept the loan and repay the amount of money to the lender.¹⁶⁹ In addition the borrower has to pay interest on the loan amount,¹⁷⁰ so that the contract consequently is also concluded against consideration¹⁷¹, i.e. any kind of service in return. The bank will pay out the loan to the borrower, based on the condition precedent, that the funds have been collected from the investors. Subsequently the borrower has to repay the loan amount and additionally interest, in monthly instalments.

b) Loan Brokerage Agreement

The platform operator enters into a loan brokerage agreement (*Kreditvermittlungsvertrag*) with the borrower according to sec. 655 a (1) BGB, regarding the brokerage of a loan agreement between the partner bank and the borrower.

A loan brokerage agreement can only be concluded between a business as defined in sec. 14 (1) BGB and a consumer as defined in sec. 13 BGB.¹⁷² The platform operator is a company, i.e. a legal person, who concludes the contract with the borrower, a consumer, within her commercial capacity and as such a business within the meaning of sec. 14 (1) BGB.

The contract is concluded through offer and acceptance according to sec. 145, 147 BGB.

¹⁶⁷ Palandt/Weidenkaff, par. 492, Rn. 2

¹⁶⁸ Jauernig/Berger, par. 488, Rn. 12

¹⁶⁹ Palandt/Weidenkaff, par. 488, Rn. 8

¹⁷⁰ Ibid., Rn. 14

¹⁷¹ Ibid., par. 491, Rn. 3

¹⁷² Jauernig/Mansel, BGB, par. Vor. 655a, Rn. 2

The subject matter of the contract and as such the obligation of the mediator is the brokerage or the proof of brokerage of a loan agreement within the meaning of sec. 491 (1) BGB.¹⁷³ Brokerage, i.e. the arrangement of a contract between two other parties, is the deliberate initiation of the willingness of the lender to conclude a contract, whereas the proof of brokerage is the evidence of a sufficient possibility of the conclusion of a contract.¹⁷⁴ The contract between the platform operator and the borrower is concluded in order to mediate a consumer loan agreement between the partner bank and the borrower, so that its subject matter is the brokerage of a loan agreement. The purpose of the loan agreement also has to lie within the consumer's scope and needs to be addressed in the contract.¹⁷⁵

Furthermore the loan broker has to receive compensation for his activity, i.e. a monetary payment or other agreed economic advantage.¹⁷⁶ Each borrower has to pay a service fee for the brokerage of the loan, which is deducted from the loan amount that is paid out to the borrower by the platform operator. The broker, the platform operator, thus receives a compensation.

3. Contractual relations with the investors

a) Assignment and Purchase Agreement

The bank enters into an assignment purchase Agreement (*Forderungskauf- und Abtretungsvereinbarung*) with the associated entity regarding the sale and transfer of a future repayment claim and transfers the future repayment claim to the associated entity according to sec. 433 (1), 398 BGB.

The bank and the associated entity need to agree upon the transfer of the respective claim according to sec. 398, 145, 147 BGB; no specific form is required for the agreement.¹⁷⁷ The claim that is to be transferred needs to exist and needs to be identifiable.¹⁷⁸ Future repayment claims can also be the subject matter of a transfer agreement,¹⁷⁹ if the claims

¹⁷³ Ibid., par. 655a-655e, Rn. 3

¹⁷⁴ Palandt/Sprau, par. 655 a, Rn. 2

¹⁷⁵ Ibid.

¹⁷⁶ MüKoBGB/Bd. 4/Schürnbrand, par. 655a, Rn.11

¹⁷⁷ Palandt/Grüneberg, par. 398, Rn. 5, 6

¹⁷⁸ Jauernig/Stürner, BGB, par. 398, Rn. 11

¹⁷⁹ Ibid.

are identifiable at the time of their creation¹⁸⁰. The subject matter of the purchase agreement is the future repayment claim of the borrower, payable to the associated entity. These repayment claims are already identifiable in terms of the debtor and the amount of the instalments at the time of the conclusion of the consumer loan agreement. The purchase agreement is thus concluded in relation to a future claim, that is already identifiable and as such a valid subject matter.

The transferor is hence obliged to transfer the claim to the transferee, so that the position of the creditor is transferred from the assignor to the assignee.¹⁸¹ Hence, the bank needs to transfer the claim to the associated entity.

b) Receivables Purchase Agreement

The associated entity enters into a receivables purchase agreement (*Vereinbarung über Verkauf, Abtretung und entgeltliche Verwaltung künftiger (Teil-)Forderungen aus einem Verbraucherkreditvertrag*) with each of the investor(s) participating in the relevant credit project according to sec. 433 (1), 398 BGB, regarding the sale and transfer of the future repayment and interest claims (“repayment claim”) under the loan and transfers the future repayment claim to the investors on a *pro rata* basis, corresponding to the relevant investor’s commitment, subject to the condition precedent that the loan has been extended to the borrower and the bank has transferred the repayment claim to the associated entity.

The associated entity and the respective investor need to agree upon the transfer of the claim according to sec. 398, 145, 147 BGB.¹⁸² The respective claim is created in form of the purchase agreement according to sec. 433 (1) BGB between the bank and the associated entity as described above.

However the sale and transfer is subject to two conditions precedent: first, that the loan has been extended to the borrower and second, that the bank has transferred the repayment claim to the associated entity. It is therefore questionable whether this claim can be the subject matter of the transfer agreement. However a transfer agreement can also be concluded in relation to a claim that is subject to either a condition precedent or a

¹⁸⁰ Palandt/Grüneberg, par. 398, Rn. 14

¹⁸¹ Ibid., Rn. 18

¹⁸² Palandt/Grüneberg, par. 398, Rn. 5

condition subsequent, the transferee just needs to be authorised to collect the claim.¹⁸³ The investors consequently need to be authorised to collect the claim from the associated entity, which is regulated in the consumer loan agreement.

F. Do peer-to-peer lending platforms have sufficient incentives to conduct thorough risk assessments?

It has been seen how peer-to-peer platforms operate and that they fulfil the same finance functions as traditional intermediaries. However there is some concern that the platform is not incentivized to conduct a thorough risk assessment of its borrowers as it is not lending its own money and hence does not bear the credit risk.¹⁸⁴ This shall be investigated in further detail below.

As has been described above, information asymmetries exist between the platform and potential investors. The platform conducts a risk assessment of the borrower and discloses the information to the investors. The investors therefore have to trust and rely on the information provided by the platform and trust that an efficient risk assessment has been conducted taking into consideration all relevant aspects.

The relationship between the two parties is therefore one dominated by trust, trust of the investors in the sound risk assessment practices of the platform. The platform hence has a reputation to build and to uphold. Peer-to-peer platforms mainly target retail investors, who are relatively risk-averse. They consequently need to deliver strong net returns and show investors that they offer sound investment opportunities.¹⁸⁵ Unsound risk assessment practices or the choice to let non-solvent borrowers onto the platform will result in the default of borrowers and the loss of the investors' goodwill, i.e. a rapid feedback loop from increasing default losses to loss of reputation,¹⁸⁶ which ultimately leads to a loss of investors, reputation and money quickly. Not only in order to uphold its reputation, but also to survive the competition with other, traditional players, peer-to-peer platforms therefore need to fulfil the same standards as traditional players in order to

¹⁸³ Ibid.

¹⁸⁴ Oxera, The economics of peer-to-peer lending, p. 51

¹⁸⁵ Ibid., p. 52

¹⁸⁶ Cf. Ibid., p. 19, 20

attract and keep customers.¹⁸⁷ They need to show, that they do not merely match borrowers and investors, but that they match investors with borrowers who are creditworthy and pay risk-reflecting interest rates.¹⁸⁸

The question thus arises whether reputation is or can be the only incentive for the platform to conduct sound risk assessments.

The platform furthermore could have a monetary incentive: The commission from the borrower is usually deducted from the loan amount, so that the platform receives this commission upfront. This could lead to the conclusion that the platform has an incentive to attract as many borrowers as possible in order to receive as much commission as possible, irrespective of the borrowers' quality. *Klöhn* and *Hornuf* argue in relation to crowdfunding platforms, that at least in the medium-term such platforms have an incentive to attract as many customers, even if non-profitable.¹⁸⁹ This however is a very one-sided argument. One has to acknowledge that a peer-to-peer platform, be it crowdfunding or crowdlending, is a two-sided marketplace, which can only survive if it can attract and supply both parties. If a lot of non-profitable borrowers are attracted, at a first glance, this surely leads to the intake of a lot of upfront commissions. However these upfront commissions from the borrowers are only part of the revenue of the platform. The other part of its revenue is made from commissions from the servicing of the loan as well as commissions from the investors. Consequently if borrowers default, this does not affect the upfront commissions, but the other commissions, which leads to a direct revenue impact for the platform.¹⁹⁰ The platform therefore has a strong incentive to conduct a sound risk assessment of borrowers in order to properly assess their credit default risk. Additionally the two-sided-marketplace-character also strengthens the reputation argument: borrowers' loans will only be funded if the investors trust the platform's credit risk assessment, otherwise if the platform is known for unsound practices, investors will not come back or will not come at all and the platform ultimately will lose money.¹⁹¹

¹⁸⁷ Cf. *Ibid.*, p. 52

¹⁸⁸ Cf. *Ibid.*, p. 52; cf. also Schäfer/Ott, *Lehrbuch der ökonomischen Analyse des Zivilrechts*, p.546: extrapolation principle: future behaviour will be judged by past behaviour

¹⁸⁹ *Klöhn/Hornuf*, *Crowdfunding in Deutschland*, p. 258

¹⁹⁰ Cf. *Oxera*, *The economics of peer-to-peer lending*, p. 52

¹⁹¹ Cf. *Bradford*, *Regulating Investment Crowdfunding*, p. 382

Besides, one could argue that the platform is indifferent as it does not typically invest its own money. Therefore it does not have an incentive at all, neither towards, nor against sound risk assessment practices. However a lot of platforms also invest their own money, mostly in order to fund loans that otherwise would not be funded completely.¹⁹² Hence the argument that the platform could cherry-pick borrowers does not uphold. Nonetheless, the platform would have no way of knowing which borrowers receive a better credit rating till after the risk assessment, which ultimately would lead to the conclusion, that even if the platform cherry-picked loans, it would still have a strong incentive to conduct efficient risk-assessments, as it would directly be affected by the borrowers default, which would lead to direct revenue impacts.¹⁹³

As said above, peer-to-peer platforms primarily target risk-averse retail investors. However institutional investors start to invest in peer-to-peer loans as well.¹⁹⁴ Institutional investors usually conduct thorough due diligences before making an investment, which indicates their approval of peer-to-peer platforms' credit risk models. Furthermore research¹⁹⁵ has shown that peer-to-peer platforms operate credit risk assessments that are in line with those used by traditional lenders.¹⁹⁶ Additionally peer-to-peer platforms implement a multi-step process including credit bureau scores.¹⁹⁷

Banks in general have one advantage with respect to existing customers, they have an account with the bank and it is therefore possible for the bank to take the account and transaction information into account as well. However in relation to non-bank customers, banks have a blind spot or need to request paper-based copies of the account information for a specified period of time. Banks usually ask for the following information during the registration process: state of living (rent or own property), employer, position, income (monthly net income and other), expenses (rent, credit card, maintenance, etc.) and request a credit bureau report as well as an identification verification.¹⁹⁸

¹⁹² Cf. Lendico research

¹⁹³ Cf. Oxera, The economics of peer-to-peer lending, p. 19, 52

¹⁹⁴ Ibid., p.26

¹⁹⁵ Ibid., p. 19

¹⁹⁶ Lendico for example conducts the credit risk assessment of the borrower on behalf of its partner bank (*Auftragsdatenverarbeitung*) and hence bases its credit risk assessment on the industry standard SCHUFA score.

¹⁹⁷ Cf. Oxera, The economics of peer-to-peer lending, p. 21

¹⁹⁸ Research: investigation of online registration for consumer loans at *inter alia* Deutsche Bank

Most peer-to-peer lending companies have built their application processes to match banks' with the aim to automate as much as possible and conduct as little as possible offline, while at the same time complying to the same standards.¹⁹⁹ Peer-to-peer lending platforms hence face the same challenges as banks with non-bank customers, they cannot access their customers' bank account information and hence would have to request paper-based documentation as well. However in recent years, bank scraping has become more and more popular. It is a process that enables any company to access a potential customer's bank account information via Application Programmable Interfaces (API).²⁰⁰ The customer enters his/her online bank account details to verify the bank account and the company is hence able to see pre-specified financial accounts and transaction details for a predefined period of time.²⁰¹

Furthermore credit risk assessments conducted by financial technology platforms have in recent years gone beyond traditional credit risk assessments conducted by banks. Financial technology companies aim to take a more holistic approach and include a variety of information that can be gathered about a person online. Similar to bank scraping, they screen scrape also other information sources, such as eBay, Amazon and PayPal transactions as well as social networks, such as Facebook, LinkedIn, Twitter.²⁰²

This shows that although the platform also has a monetary incentive, its reputation amongst investors constitutes its greatest incentive for a sound risk assessment of the borrowers. As *Bradford*²⁰³ argues, the platform should be a "neutral, unbiased gatekeeper", which can help to protect investors from fraud. The platform is merely a facilitator for borrowers to get access to funding and investors to get access to an investment opportunity.

¹⁹⁹ Cf. Fn. 12

²⁰⁰ A company offering such a service is e.g. Yodlee

²⁰¹ https://developer.yodlee.com/API_Resources/Integration_Guide

²⁰² Cf.: https://www.bitbond.com/de/terms_of_use

²⁰³ Bradford, *Regulating Investment Crowdfunding*, p. 382

Part III: The regulation of peer-to-peer lending platforms in the consumer credit market in selected European countries

A. Regulation of peer-to-peer platforms in Germany

I. Regulation of consumer lending in relation to peer-to-peer lending

1. General principles

First, it will be investigated how lending is regulated in Germany and next which license requirements arise for the platform operator under German Law. In Germany, no special regulations exist for peer-to-peer lending platforms yet. Therefore peer-to-peer lending needs to comply with the same rules as traditional financial institutions in relation to banking supervision and loan regulation.

Banks and financial service providers are supervised and controlled by the German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – “**Bafin**”). Its primary objective is to ensure the functioning, stability and integrity of the German financial system.²⁰⁴

The conduct of banking business and the provision of financial services are regulated in the German Banking Act (*Kreditwesengesetz* – “**KWG**”) and the provision of payment services is regulated in the German Payment Services Supervision Act (*Zahlungsdienstaufsichtsgesetz* – “**ZAG**”), implementing the European Payment Services Directive (2007/64/EC) (Directive 2007/64/EC of the European Parliament and of the Council on payment services in the internal market – “**PSD**”). The conduct of banking business or the provision of financial services in Germany on a commercial basis or on a scale that requires a commercially organised business undertaking requires a license from Bafin according to sec. 32 (1) sent. 1 KWG. The same applies according to sec. 8 (1) ZAG, with regards to the provision of payment services. Hence the platform operator would either have to apply for a banking license in order to being able to grant credits itself or cooperate with a bank to grant the credits and in that case being subject to other license requirements.

²⁰⁴ Bafin, brochure: Die Bafin stellt sich vor, p. 2

2. Legal analysis

The peer-to-peer platform engages in different activities, which include among others the mediation of loans and the sale and transfer of repayment claims through an associated entity as well as the servicing in relation to defaulted payments. The platform operator and its associated entity could consequently be subject to certain license requirements under German law. The operation of a peer-to-peer platform could amount to a commercial business within the meaning of the German Trade Regulations Act (*Gewerbeordnung* – “**GewO**”) and thus trigger a license requirement according to sec. 34c (1) sent. 1 no. 2 GewO. Furthermore it needs to be investigated whether the business involves banking business in the form of credit business within the meaning of sec. 1 (2) no. 2 KWG or financial services in the form of factoring according to sec. 1, 1a (2) no. 9 KWG which would lead to a license requirement pursuant to sec. 32 (1) KWG. Additionally the business could involve payment services in the form of money remittance within the meaning of sec. 1, 2 no. 6 ZAG which would lead to a license requirement according to sec. 8 (1) ZAG. A registration could furthermore be required under the German Legal Services Act (*Rechtsdienstleistungsgesetz* – “**RDG**”) for debt collection. These license requirements will be analysed below.

a) Basis for the analysis

The analysis, which license requirements apply, will be conducted with regards to indirect peer-to-peer lending in relation to the process sequence initiated via the platform and its associated entity as described above in the exemplary description of peer-to-peer lending as conducted in Germany. Due to the requirement of a banking license from Bafin, direct peer-to-peer lending, as conducted in other European countries, will not be subject to the analysis, because the platform operator would be required to be a bank. However the objective of this dissertation is to analyse the regulation of peer-to-peer platforms, not banks. The license requirements under German law will therefore be analysed in relation to indirect peer-to-peer lending, which is conducted in Germany.²⁰⁵

²⁰⁵ Examples include: auxmoney.com, lendico.de

b) Statutory permission according to the GewO

aa) Principle of freedom of trade

In principle it is permitted for anyone to operate a commercial business according to sec. 1 (1) GewO, except in the instances where the GewO regulates exceptions and restrictions. This also follows from the basic right to professional freedom according to art. 12 of the German Constitution (*Grundgesetz* – “GG”) which aims to avert any measures that restrict this freedom.²⁰⁶

Occupation or profession is every permanent activity that helps in the development and maintenance of a basis for life.²⁰⁷ The activity is permanent if it is not only conducted once, but rather intended to be long-term or long lasting.²⁰⁸ It merely needs to be conducted with the purpose of developing and maintaining a basis for life, however it need not yield a lot of income, even if it would not be sufficient to support the basis of life.²⁰⁹ The extent of protection (*Schutzbereich*) covers both the freedom of choice of one’s occupation as well as the freedom of exercising one’s profession.²¹⁰ However art. 12 GG primarily covers one’s profession or occupation, not commercial business within the meaning of the GewO. Nevertheless the extent of protection also includes the freedom of trade and enterprise, i.e. the free foundation and management of a commercial enterprise²¹¹ as well as dependent alternatives of professional occupations²¹².

Interferences with the professional freedom that require a justification need to have a tendency that subjectively or objectively regulates a profession or occupation (*subjektiv oder objektiv berufsregelnde Tendenz*).²¹³ The gradual theory (*Stufentheorie*) developed by the Federal Constitutional Court (*Bundesverfassungsgericht* – “BVerfG”) differentiates between three types of interventions and thus three different levels of justifications: (1) restrictions on the exercise of one’s profession are legitimate if they are necessary to protect reasonable interests of the general public, (2) the choice of one’s profession can be interfered with if the interferences are justified by particularly important

²⁰⁶ BeckOK GewO/Pielow, par. 1 GewO, Rn. 77, 78

²⁰⁷ BVerfGE 78, 179, 193

²⁰⁸ BeckOK GewO/Pielow, par. 1 GewO, Rn. 95; BVerfGE 97, 228, 253

²⁰⁹ Jarass/Pieroth, GG, art. 12 GG, R. 4 f.

²¹⁰ Beck-OK GewO/Pielow, sec. 1, Rn. 91

²¹¹ BVerwGE 71, 183, 189

²¹² BVerfGE 50, 290, 362

²¹³ BVerfGE 97, 228, 254

interests of the general public, and (3) if the choice of one's profession is restricted by preconditions that need to be fulfilled before the pursuit of such a profession, one needs to distinguish subjective and objective restrictions in order to determine the extent of its justification.²¹⁴

The first level covers regulations concerning the mere modalities of the exercise of one's profession like, *inter alia*, regulations concerning pricing, opening hours, advertisements, information obligations etc.²¹⁵ The choice of one's profession can be either subjectively or objectively restricted.²¹⁶ Subjective restrictions on the admission to a profession are subjective admission criteria that are inherent in the applicant as a person such as education, qualifications, knowledge, experience, achievements, characteristics, skills and abilities,²¹⁷ while objective restrictions on the admission are objective criteria that are not inherent in the applicant, do not relate to his/her qualifications and which therefore cannot be influenced by him/her, they have an absolute blocking effect on all those affected²¹⁸.

The freedom of the choice of one's profession can consequently only be restricted, if the protection of particularly important community goods (*besonders wichtige Gemeinschaftsgüter*) so requires and lesser means with a lower restriction are not available. This is due to the fact that regulations within the meaning of art. 12 (1) sent. 2 GG always have to be executed in a way that leads to the lowest form of an interference.²¹⁹ The legislator is only allowed to choose a more invasive interference, if the feared dangers cannot be tackled effectively with the constitutional means.²²⁰ These preconditions are fulfilled due to the imperative protection of the consumer from economic damage and due to the fact that the prohibition according to sec. 35 GewO is not sufficient.²²¹

²¹⁴ Maunz-Dürig, GG, art. 12, Rn. 335

²¹⁵ Ibid., Rn. 343

²¹⁶ Ibid., Rn. 351

²¹⁷ Ibid., Rn. 335, 355

²¹⁸ Ibid., Rn. 363

²¹⁹ Ibid., Rn. 335

²²⁰ Marcks, Marcks, MaBV, sec. 34c GewO, Rn. 60

²²¹ Ibid.

bb) Mediation of loan contracts

Commercial business within the meaning of the GewO is an undefined legal term, which has been defined by jurisprudence and legal theory. It is any independent and permanent occupation with the intent to realise a profit that is not per se prohibited and that is not an independent profession (*freier Beruf*).²²² The overall picture of the business is of material importance in determining whether it falls within the scope of the definition. Both the platform operator and its associated entity conduct an independent and permanent business with the intent to realise a profit, that is not per se prohibited and hence commercial business within the meaning of the GewO.

Whoever mediates the conclusion of loan contracts or proves the opportunity of the conclusion of such contracts on a commercial basis requires a license from the respective authority according to sec. 34c (1) sent. 1 no. 2 GewO, as long as there are no reasons for denial according to paragraph 2 or exceptions for financial institutions in paragraph 5. The license requirement under sec. 34c (1) sent. 1 GewO is a subjective restriction on the choice of one's profession that is in line with art. 12 (1) GG²²³ and from which a requirement to grant the license if its requirements are met follows²²⁴.

It is a personal license, i.e. related to one single (natural/legal) individual. Consequently, if more than one natural person or legal entity is required to operate under such a license, each single person or entity must apply for a license.²²⁵ Both the platform operator and the associated entity are companies and thus the question arises whether they are legal entities within the meaning of sec. 34c GewO. According to sec. 13 (1) German Limited Liability Company Act (*Gesellschaft mit beschränkter Haftung (GmbH) Gesetz – “GmbHG”*), a limited liability company has her own rights and responsibilities, she can acquire property and property rights and be plaintiff and defendant in a legal trial. A limited liability company therefore is a legal entity, she has her own legal personality and hence, through listing in the commercial register, legal capacity (*Rechtsfähigkeit*).²²⁶ The legal capacity is extensive, i.e. the GmbH can exercise all rights and obligations under

²²² BeckOK GewO/Pielow, par. 1 GewO, Rn. 135

²²³ Marcks, MaBV, par. 34c GewO, Rn. 60

²²⁴ BeckOK GewO/Will, par. 34c GewO, Rn. 54

²²⁵ Ibid., Rn. 80, 81

²²⁶ Baumbach/Hueck/Fastrich, GmbHG, par. 13, Rn. 2 and cf. par. 11 GmbHG: the limited liability company does not exist as such before it is listed in the commercial register

private law, as long as they are not explicitly restricted to natural persons or due to their content; she is also subject to basic rights according to art. 19 (3) GG.²²⁷ The platform operator and the associated entity are both GmbHs and consequently as legal entities subject to the license requirement, if they qualify as mediator within the meaning of sec. 34c (1) sent. 1 no. 2 GewO.

Mediation within the meaning of sec. 34c (1) 1 no. 2 GewO is the mediation of loans according to sec. 488 (1) BGB. A loan within the meaning of sec. 488 ff. BGB is an act whereby a lender grants a borrower a certain amount of money that has to be repaid by the borrower together with interest after the due date.²²⁸ Characteristically for mediation is the involvement of a third party as mediator. Consequently a business does not qualify as mediation if the mediator is also the grantor of the loan, as then a third party is missing.²²⁹ Indirect peer-to-peer lending as conducted in Germany however is qualified by the involvement of a third party, a partner bank, which acts as grantor of the loan.

Sec. 34c (1) 1 no. 2 GewO requires the mediation of loans or at least proof of the opportunity to mediate. Mediation is every activity that is aimed at concluding a contract; it is both an activity that prepares the mediation of a contract as well as an activity that leads to the mediation of a contract, even in case the mediation is not successful.²³⁰ Proof of the opportunity to conclude a contract is given, if the business can provide a potential customer's name and address to the client in order for the client to being able to start negotiations.²³¹

Indirect peer-to-peer lending is based on a partnership between a peer-to-peer operator and a bank and the concept, that the platform operator assists in the conclusion of a contract between the bank and the borrower. The platform operator and the borrower enter an agreement regarding the mediation of a loan contract with the bank. The platform operator thus carries out activities for the bank, enabling the bank to enter in a loan agreement with the borrower. Due to the conclusion of a loan brokerage agreement, the platform operator is also able to provide potential customers' names and their respective

²²⁷ Ibid., Rn. 3

²²⁸ Landmann/Rohmer/Marcks, GewO, par. 34c, Rn. 24

²²⁹ Ibid., Rn. 25

²³⁰ Ibid., Rn. 8

²³¹ Ibid., Rn. 13

addresses to the bank in order for the bank to conclude a contract. However, the bank ultimately decides, whether to conclude a contract with a respective borrower. This nevertheless does not prevent the conclusion of defining the platform operator as mediator, even if the mediation does not lead to the conclusion of a contract, since the mediation does not need to be successful, the activity just needs to aim at the conclusion of a contract. The loan is granted by the bank, not the platform operator, so that the mediator is not the lender of record. If the mediation is successful, the bank concludes a loan contract with the borrower within the meaning of sec. 491 (1) BGB and the bank subsequently grants a loan to the borrower, i.e. a certain amount of money that has to be paid back together with interest after the due date. Otherwise, in case the loan contract is not concluded, the platform operator can show proof of the opportunity to mediate a loan contract. The platform operator consequently qualifies as a mediator of loan contracts within the meaning of sec. 34c (1) no. 2 GewO and hence requires a license under the GewO.

c) Statutory permission according to the KWG

Bafin published an explanatory leaflet (*Merkblatt*) with advice on the statutory permission of the operators and users of internet based credit intermediation platforms in May 2007 arguing, that the mere intermediation of loans, as conducted under indirect peer-to-peer lending in Germany, does not qualify as banking business, but could fall within the regulation of the GewO.²³² However, since Bafin investigates the license requirement on a case-by-case basis, platform operators and/or investors could be deemed to conduct deposit or credit business, based on the specific business model and contractual framework.²³³ Hence it needs to be investigated whether indirect peer-to-peer lending as conducted in Germany falls within the regulation of sec. 32 KWG in connection with sec. 1 para. 1 sent. 1 no. 1 or 2 KWG and hence qualifies as banking business.

aa) Banking business

Banking business is defined in sec. 1 (1) KWG along examples like, *inter alia*, the acceptance of moneys (see sec. 1 (1) 2 no. (1) KWG) or the granting of money and the

²³² Bafin, Merkblatt, Hinweise zur Erlaubnispflicht der Betreiber und Nutzer einer internetbasierten Kreditvermittlungsplattform nach dem KWG, sec. 1

²³³ Ibid., sec. 1, 2

acceptance of credit (see sec. 1 (1) 2 no. 2 KWG). These activities need to be conducted by a credit institution within the meaning of sec. 1 (1) 1 KWG, which is a company that undertakes banking business on a commercial basis or on a scale that requires a commercially organised business undertaking.²³⁴

(1) Deposit business

Deposit business is defined in sec. 1 (1) 2 no. 1 KWG as the acceptance of moneys as deposit or other non-conditional repayable money from the public, provided that the repayment claim is not confirmed by a bearer bond or negotiable bond.

In order to qualify as deposit business, repayable moneys have to be accepted from the public. Acceptance is defined as the physical acceptance of money or the crediting to one's account in case of cashless payments,²³⁵ i.e. to reach the power of disposition (*Verfügungsbefugnis*) of the acceptor, who does not merely act as messenger (*Bote*) for a third party.²³⁶ The acceptance from third parties generally qualifies as acceptance from the public in relation to this regulation.²³⁷ The moneys furthermore have to be repayable, i.e. the investors need to have a claim against the platform operator and/or the associated entity for repayment of a specified amount²³⁸, and non-conditional, i.e. the repayment could not be dependent on a future, uncertain incident.²³⁹

The investors could pay the respective amount they invest in the loans to the platform operator. The platform operator then would accept money from third parties. Since the money would be given to the platform with the intention to fund borrowers' loans and with the expectation to receive it back in instalments, plus interest, the money were repayable. Bafin also takes the view that this would qualify as deposit business.²⁴⁰ German peer-to-peer platforms however usually do not offer own accounts to investors, but they rather offer investors to open so called 'investor (bank) accounts' at their

²³⁴ Boos/Fischer/Schulte-Mattler/Schäfer, KWG, par. 1, Rn. 8

²³⁵ Cf. Bafin, Merkblatt Einlagengeschäft, sec. I. 2.

²³⁶ Cf. also Renner, Banking Without Banks, p. 265

²³⁷ Cf. Bafin, Merkblatt Einlagengeschäft, sec. I. 3.

²³⁸ Cf. Bafin, Merkblatt, Hinweise zur Erlaubnispflicht der Betreiber und Nutzer einer internetbasierten Kreditvermittlungsplattform nach dem KWG and Fn. 46

²³⁹ Cf. also Renner, Banking Without Banks, p. 265

²⁴⁰ Bafin, Merkblatt, Hinweise zur Erlaubnispflicht der Betreiber und Nutzer einer internetbasierten Kreditvermittlungsplattform nach dem KWG

partnering credit institution,²⁴¹ thereby circumventing the requirement of being subject to banking regulation.

(2) Credit business

Under indirect peer-to-peer lending, the platform operator does not grant money or accept credits within the meaning of sec. 1 (1) 2 no. 2 KWG. As described above the money is granted by a partner bank and the platform operator mediates the conclusion of the loan contracts, but is not part of the chain of transfers of the repayment claims or the cash flows arising from the granting of the loans. Loan mediation as such however does not qualify as banking business within the meaning of the KWG as otherwise the special license requirement according to sec. 34c (1) GewO would not be necessary.

The acquisition of repayment claims from the bank and transfers of such repayment claims to the investors on a *pro rata* basis could nevertheless qualify as credit business, which is yet unsolved.²⁴²

According to Bafin the granting of loans and the acquisition of loan repayment claims need to be distinguished.²⁴³ The loan is paid out by a licensed credit institution and this credit institution is subject to the obligations under the loan contract. Furthermore no loan contract is concluded between the borrower and the assignee and additionally the sale and transfer of repayment claims is governed by sales law. But the assignee may subsequently become the grantor of a loan, in case of, *inter alia*, deferral, prolongation or other restructuring measures. The platform operator does however merely assist the bank in exercising its right under the loan agreement as agent on behalf of the investors and the associated entity will not take such actions. Consequently neither the platform operator, nor its associated entity are credit institutions and do not conduct banking business within the meaning of sec. 1 (1) KWG.

²⁴¹ Cf. Lendico sec. 6.5. of Lendico's Terms and Conditions for Private Investors

²⁴² Cf. Renner, Banking Without Banks, p. 267

²⁴³ Bafin, Merkblatt, Hinweise zum Tatbestand des Kreditgeschäfts., sub. sec. 1 a) bb) (4)

bb) Financial services

The platform operator and/or the associated entity could conduct financial services according to sec. 1 KWG, which is defined along examples.

(1) Financial service institution

Financial service institutions are companies that undertake financial services, as set out in sec. 1 (1a) sent. 2 no. 1 - 12 KWG, on a commercial basis or on a scale that requires a commercially organised business undertaking.²⁴⁴ According to the German Federal Bank, in order to be considered to be conducted on a commercial basis, intent to realise a profit is required and it needs to be considered whether the commercially organised business undertaking is objectively required.²⁴⁵ Below the different financial services will be analysed in order to determine whether the platform operator and/or its associated entity qualify as financial service institution(s).

(2) Investment brokerage

Investment brokerage (*Anlagevermittlung*) involves the business of brokerage in relation to the purchase or sale of financial instruments according to sec. 1 (1a) 2 no. 1 KWG.²⁴⁶ The platform operator or its associated entity would have to act upon receipt and delivery of investors' orders.²⁴⁷ Investment brokerage is defined as every final action that is intended to conclude business in relation to the purchase and sale of financial instruments.²⁴⁸ First of all it should be examined whether peer-to-peer lending involves the brokerage of financial instruments within the meaning of sec. 1 (11) KWG. Although investments within the meaning of sec. 1 (2) Capital Investment Act (*Vermögensanlagengesetz* – "**VermAnlG**") do also fall within the scope of sec. 1 (11) KWG due to a reference, the mere mediation of loans, as conducted by peer-to-peer lending platforms, is not covered.²⁴⁹ Consequently the platform operator of an indirect peer-to-peer lending platform does not conduct investment brokerage, neither does its associated entity.

²⁴⁴ Boos/Fischer/Schulte-Mattler/Schäfer, KWG, par. 1, Rn. 117

²⁴⁵ Bundesbank, Merkblatt Finanzdienstleistungen gemäß § 32 Abs. 1 KWG, p. 2

²⁴⁶ Boos/Fischer/Schulte-Mattler/Schäfer, KWG, par. 1, Rn. 122

²⁴⁷ Cf. Bundesbank, Merkblatt Finanzdienstleistungen gemäß § 32 par. 1 KWG, p. 4

²⁴⁸ Boos/Fischer/Schulte-Mattler/Schäfer, KWG, par. 1, Rn. 134

²⁴⁹ Ibid.

(3) Investment advice

The platform operator could give investment advice (*Anlageberatung*) according to sec. 1 (1a) 2 no. 1a KWG. Investment advice are personal recommendations to the customer in relation to certain business transactions with a particular financial instrument, if the recommendations are based on the investors' personal circumstances or seem to be fitting for him/her and if the information is not distributed through channels that are intended for the public.²⁵⁰ However it is not sufficient, that the customer is merely given information or if recommendations are made to an unidentifiable group of people.²⁵¹ Rather, if the customer receives advice, i.e. someone suggests a certain activity to be in the customer's interest, the advice needs to be tailored to this customer in relation to a specific financial instrument or the advice needs to at least seem as if it were taking the personal circumstances of the customer into account.²⁵²

The platform operator does give general explanations and recommendations as well as advice to all investors as a customer group, e.g. advice on, *inter alia*, diversification of an investor's portfolio in order to minimise investment risks. The recommendations and advice are however addressed at the public at large and do not take personal circumstances, such as the individual investor's financial situation, into account. Furthermore the advice may be distributed via the platform's website and hence channels that are intended for the general public. Furthermore loans do not qualify as financial instruments within the meaning of sec. 1 (11) KWG. Consequently the platform operator does not give investment advice within the meaning of the KWG.

(4) Multilateral trade system

A multilateral trade system (*multilaterals Handelssystem*) within the meaning of sec. 1 (1a) 2 no. 1b KWG, is a system in which the interests of a number of people, who are interested in both the purchase and sale of financial instruments within the system, are subject to predefined conditions and are connected in a way that leads to a contract regarding the purchase of such financial instruments. This is the case, if the interests of individual people are combined in relation to the sale and purchase of financial

²⁵⁰ Boos/Fischer/Schulte-Mattler/Schäfer, KWG, par, Rn. 123b

²⁵¹ Bundesbank, Merkblatt Finanzdienstleistungen gemäß § 32 Abs. 1 KWG, p. 5

²⁵² Ibid., p. 5

instruments according to sec. 1 (11) KWG, without the scope of making a decision in relation to the final conclusion of a contract with a certain contractual partner.²⁵³ A platform in a technical sense is not required, but firm rules need to be in place.²⁵⁴

The investors are interested in purchasing the repayment claims in order to participate in the loan and receive interest. Likewise the bank is interested in selling the repayment claims in order to finance the loan granted to the borrower. The interests of the investors and the bank thus are connected and could lead to the conclusion of a contract. However a multilateral system is not in place if it is merely a bilateral system where the contractual partner of the sale or purchase is always the same.²⁵⁵

Due to the nature of peer-to-peer lending, the bank always sells the repayment claims to the associated entity who sells them to the respective investors. Consequently the seller of the repayment claims is always the same, the bank, so that no multilateral trade system is used.

(5) Contract brokerage

The platform operator as mediator could conduct contract brokerage (*Abschlussvermittlung*) within the meaning of sec. 1 (1a) 2 no. 2 KWG, i.e. the purchase and sale of financial instruments via open agency, in the name and on account of the customer.²⁵⁶ The platform operator would have to act in the name and on account of the investors while purchasing or selling financial instruments. But the platform operator does not sell or purchase the repayment claims from the bank in the name and on account of the investors, neither do they constitute financial instruments within the meaning of sec. 1 (11) KWG.

(6) Factoring

The platform operator and/or its associated entity could conduct factoring according to sec. 1 (1a) 2 no. 9 KWG which includes both, non-recourse factoring (*echtes Factoring*) as well as recourse factoring (*unechtes Factoring*).²⁵⁷

²⁵³ Bundesbank, Merkblatt Finanzdienstleistungen gemäß § 32 Abs. 1 KWG, p. 5

²⁵⁴ Ibid.

²⁵⁵ Ibid.

²⁵⁶ Ibid. and Boos/Fischer/Schulte-Mattler/Schäfer, KWG, par. 1, Rn. 124

²⁵⁷ Boos/Fischer/Schulte-Mattler/Schäfer, KWG, par. 1, Rn. 150b

Factoring is the continuous purchase of receivables on the basis of a framework agreement with or without recourse.²⁵⁸ Non-recourse factoring means that the credit risk is transferred to the factoring company, the assignee (*Zessionar*), so that there is no possibility to recourse to the assignor (*Zedent*).²⁵⁹ Recourse factoring, on the opposite, means that the factoring company can return the claim to the assignor, so that the credit risk lies with the assignor and recourse against the assignor is possible.²⁶⁰

In order for factoring to qualify as financial service the purchase has to be on-going, based on a framework agreement and fulfil a finance function.²⁶¹ The on-going purchase requires the repeated purchase of single claims. The first purchase already qualifies as financial service if further purchases are intended and these further purchases are regulated in the framework agreement.²⁶² The intent to effect further contracts of the same nature will be assumed by Bafin, if such intent is reflected in the contract.²⁶³ However if a framework agreement explicitly states that further requirements to purchase are excluded and determines that the conditions for every further purchase are to be negotiated anew and individually, then it does not qualify as framework agreement in the case of non-recourse factoring.²⁶⁴ For recourse factoring this does nevertheless not apply, since the contract is qualified as a civil law loan contract, which falls within the meaning of credit business in sec. 1 (1) sent. 2 no. 2 KWG. Furthermore the purchase of receivables has to involve a finance function, i.e. due to the sale of the claims, the owner will receive cash funds prior to the due date of the sold receivables.

The platform operator does not purchase any receivables and is not involved in the chain of transfers regarding the repayment claims and thus does not conduct factoring.

The associated entity is involved in the on-going purchase of receivables. This would hence have to be based on a framework agreement. However the purchase of the repayment claims from the bank is not based on predefined conditions, but rather each

²⁵⁸ Boos/Fischer/Schulte-Mattler/Schäfer, KWG, par. 1, Rn. 150b

²⁵⁹ Ibid.

²⁶⁰ Ibid.

²⁶¹ Ibid., Rn. 150c

²⁶² Ibid.

²⁶³ Bafin's general rule, cf. Bafin circular on factoring as of January 2009

²⁶⁴ Boos/Fischer/Schulte-Mattler/Schäfer, KWG, par. 1, Rn. 150c

acquisition is based on individually negotiated terms. Due to the nature of peer-to-peer lending, the conditions including the amount, duration and interest rate of the loan vary for each loan and hence need to be individually negotiated. In addition, the purchase is based on an autonomous and individual decision by the associated entity. Furthermore not the associated entity, but solely the platform operator is entitled to a fee, which is also an indication against the existence of a framework agreement. Consequently, if a set-up as such is chosen, one of the requirements for factoring, the existence of a framework agreement, is not fulfilled, so that the associated entity does not conduct factoring. The agreement nonetheless should include an explicit statement that further requirements to purchase such claims are excluded and that the conditions for every further purchase shall be negotiated separately for each purchase.

However, based on an overall assessment of the circumstances one could argue that an implicit framework agreement exists. Similarly to the bank, which accepts customers mediated by the platform operator due to a cooperation agreement, the associated entity might continuously accept sale and transfer agreements. Although the bank retains the final decision whether to grant a loan to a borrower and accept him/her as customer, the bank will from an economic and business point of view only refuse customers in very exceptional circumstances. If the bank were to refuse customers regularly, the platform operator might reconsider their relationship. The associated entity might likewise have an intrinsic business obligation to accept the sale and transfer agreements offered by the bank. This would lead to the conclusion that the autonomous and individual decision by the associated entity, whether to accept a sale and transfer agreement offered by the bank, only exists on paper. The associated entity after all assists in servicing the loans on behalf of the bank and also assists in the distribution of the loan receivables to the investors by purchasing the sale and transfer agreements, so that the bank only has one single point of contact. Consequently, it needs to be seen how Bafin will assess this case in order to determine whether the associated entity is subject to a license according to sec. 1 (1a) 2 no. 9 KWG as financial service institution conducting factoring.

Nonetheless the purchase of the claims would also have to involve a finance function. The associated entity however does not receive a real financing, but the claims constitute a mere transit item: due to the condition precedent, the purchase of the repayment claims by the associated entity is tied to the sale of such repayment claims to the investors.

Therefore the associated entity does not conduct factoring due to the lack of a finance function.

However one could also argue that this set-up circumvents the regulation of factoring in order to avoid a license a requirement and thus should fall within the scope of factoring. As stated above it will be interesting to see, how this will be assessed by Bafin.

d) Statutory permission according to the ZAG

The platform operator and/or the associated entity could qualify as payment service provider and conduct payment services according to sec. 1 ZAG. Different kinds of payment service provider exist according to the ZAG, which will be analysed below.

aa) Credit institution

Credit institutions within the meaning of sec. 1 (1) no.1 ZAG qualify as payment service provider. Thus it needs to be determined whether the platform operator and/or or its associated entity qualify as such.

A payment service provider according to sec. 1 (1) no. 1 ZAG is a credit institution within the meaning of art. 4 no. 1 of the Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (“Banking Directive”), i.e. an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account. It follows that the term credit institution within the meaning of the ZAG is more restrictive than in the KWG, where institutions have to conduct either activity, whereas within the meaning of the ZAG both activities, deposit taking and granting of credits, need to be conducted cumulatively.²⁶⁵ Consequently every credit institution and financial service institution according to the KWG which is neither a deposit bank nor an e-money institution (see also sec. 1 (1) no. 2 ZAG) will qualify as payment service provider according to sec. 1 (1) no. 5 ZAG as long as they conduct payment services according to sec. 1 (2) ZAG.²⁶⁶ Furthermore the Banking Directive and PSD both do not have a twofold term for credit institutions, i.e. deposit banks and so called partial banks

²⁶⁵ Casper/Terlau/Casper, ZAG, par. 1, Rn. 5

²⁶⁶ Ibid., Ellenberger/Findeisen/Nobbe/Findeisen, Zahlungsverkehrsrecht, par. 1, Rn. 130

(*Teilbanken*). European law rather differentiates between financial institutions and credit institutions.²⁶⁷ Sec. 1 (1) no. 1 ZAG thus encompasses all credit institutions which require a license, i.e. a permission, from Bafin according to sec. 32 (1) KWG, or which have a corresponding license from their home member state allowing them to conduct banking business within the Federal Republic of Germany.²⁶⁸

In the case of indirect peer-to-peer lending neither the platform operator nor the associated entity, but a cooperating partner bank grants credits, therefore they do not qualify as credit institutions within the meaning of sec. 1 (1) no. 1 ZAG.

bb) Payment institution

Payment institutions within the meaning of sec. 1 (1) no. 5 ZAG are enterprises that provide payment services either on a commercial basis or on a scale that requires a commercially organised business undertaking. The term commercial needs to be interpreted broadly,²⁶⁹ thus systematic and goal-oriented activities suffice,²⁷⁰ which are intended to be long-term,²⁷¹ and with the intent to realise a profit or at least employment against consideration²⁷². Payment services however do not have to represent the company's main activity.²⁷³ Every company that qualifies as payment institution needs to apply for a license from Bafin according to sec. 8 ZAG.²⁷⁴ Consequently it needs to be determined whether the platform operator and/or the associated entity conduct payment services.

Payment services are defined in sec. 1 (2) ZAG on the basis of examples, which thus will be investigated.

²⁶⁷ Ellenberger/Findeisen/Nobbe/Findeisen, *Zahlungsverkehrsrecht*, par. 1, Rn. 102

²⁶⁸ Casper/Terlau/Casper, ZAG, par. 1, Rn. 6; Schwennicke/Auerbach/Schwennicke, par. 1 ZAG, Rn. 5

²⁶⁹ Casper/Terlau/Casper, ZAG, par. 1, Rn. 11

²⁷⁰ Ellenberger/Findeisen/Nobbe/Findeisen, par. 1, Rn. 131

²⁷¹ Schwennicke/Auerbach/Schwennicke, KWG, par. 1 ZAG, Rn. 15 in connection with par. 1 KWG, Rn. 6

²⁷² Casper/Terlau/Casper, ZAG, par. 1, Rn. 11

²⁷³ Ibid.

²⁷⁴ Ibid., Rn. 12

(1) Deposit and disbursement business

Deposit and disbursement services are defined as services which enable cash items to be placed on a payment account and cash withdrawals to be made from that account.²⁷⁵ Decisive is that cash is transformed into bank money.²⁷⁶ Payment account is defined as an account held in the name of one or more payment service users which is used for the execution of payment transactions.²⁷⁷

The platform operator does not offer accounts to be opened in the name of investors, as payment service users, which are then used for the execution of payment transactions. As also described above the investors do not open accounts with the platform operator or transfer any money to accounts of the platform operator. They can rather open so called ‘investor accounts’, bank payment accounts, at the co-operating partner bank. The platform operator therefore does not offer payment accounts and consequently does not conduct deposit, nor disbursement business within the meaning of sec. 1 (2) no. 1 ZAG.

(2) Payment services

Payment services within the meaning of sec. 1 (2) no. 2 ZAG in connection with no. 3 ZAG cover three different services: direct debit, credit transfers and business with payment cards. All of these payment services require a payment transaction within the meaning of sec. 675 f (3) sent. 1 BGB,²⁷⁸ which is every supply, transfer or withdrawal of an amount of money. It means an act, initiated by the payer or on his behalf or by the payee, of placing, transferring or withdrawing funds, irrespective of any underlying obligations between the payer and the payee, i.e. the cashless transfer of a payable amount from the payer’s account to the payee’s account²⁷⁹.

Direct debit is legally defined in paragraph 4 as a payment service for debiting a payer’s payment account, where a payment transaction is initiated by the payee based on the consent given by the payer to the payee, to the payee’s payment service provider or to the

²⁷⁵ Ibid., Rn. 19

²⁷⁶ Ibid.

²⁷⁷ Cf. art. 4 no. 12 PSD

²⁷⁸ Casper/Terlau/Casper, ZAG, Rn. 28

²⁷⁹ Ibid.

payer's own payment service provider. Direct debit hence is characterised by the fact that the payment is initiated by the payee, i.e. the creditor, not the debtor.²⁸⁰

Credit transfer means a payment service for crediting a payee's payment account with a payment transaction or a series of payment transactions from a payer's payment account by the payment service provider which holds the payer's payment account, based on an instruction given by the payer.²⁸¹ The transferring credit institution is obliged to make the amount of money available to the payee's account, if it is serviced by the same institution, or the payee's payment service provider due to the underlying payment order.²⁸²

Business with payment cards has not been defined legally, so that the definition of payment instrument of art. 4 no. 14 PSD, shall be used, which is defined as personalised device(s) and/or set of procedures agreed between the payment service user and the payment service provider and used in order to initiate a payment order. A payment order needs to be issued by the card or similar object and the card needs to be personalised in order to enable an identification of the payer, either through a signature or personal identification number (PIN).²⁸³ However since payment card refers to a physical object, non-physical personalised procedures, like e.g. online banking, have to be excluded.²⁸⁴

The platform operator is not involved in any payment transactions and hence cannot conduct direct debit or credit transfers. Furthermore it is not part of the business to offer payment cards, since the platform operator does not even operate a payment account system. The platform operator therefore does not conduct payment services. The associated entity likewise does not issue payment cards. It does however receive payments from the investors and forwards them to the bank. Nonetheless the associated entity does not conduct credit transfers for the investors, but receives an amount of money to its bank account via a transfer and then transfers such amount to the bank in discharge of its own payment obligation. But, the associated entity could conduct direct debit services, if such an agreement were concluded with the investors. Instead of having to

²⁸⁰ Ibid., Rn. 34, cf. art. 4 no. 23 PSD

²⁸¹ Casper/Terlau/Casper, ZAG, Rn. 29; cf. art. 4 no. 24 PSD

²⁸² Casper/Terlau/Casper, ZAG, Rn. 30

²⁸³ Ibid., Rn. 42

²⁸⁴ Ibid.

transfer the purchase price for the repayment claim to the associated entity, it could be authorized to debit such an amount from the investors account.

(3) Money remittance business

The platform operator and/or associated entity could conduct money remittance business within the meaning of sec. 1 (2) no. 6 ZAG, which nearly corresponds to sec. 1 (1a) sent. 2 no. 6 KWG and implements art. 4 no. 12 of the PSD²⁸⁵. Money remittance business is a service where funds are received from a payer, without any payment accounts being created in the name of the payer or the payee, for the sole purpose of transferring a corresponding amount to a payee or to another payment service provider acting on behalf of the payee, or where such funds are received on behalf of and made available to the payee. The payment services do however not have to be conducted via payment accounts.²⁸⁶ Sec. 1 (2) no. 6 ZAG distinguishes between two alternatives: (1) the transfer of the payer's funds for the sole purpose of transferring a corresponding amount to the payee or to another payment service provider acting on behalf of the payee without any payment accounts being created (no. 6 alt. 1), and (2) where such funds are received on behalf of and made available to the payee (no. 6 alt. 2).²⁸⁷

The first alternative is an omnibus clause (*Auffangtatbestand*) which covers cases where the payer makes funds available to a payment service provider either in cash, via cheque, transfer or PayPal.²⁸⁸ The service provider then has to transfer a corresponding amount to a recipient or to another payment service provider commissioned by the recipient.²⁸⁹ Two prerequisites have to be fulfilled in order for the first alternative to be applicable: (1) no payment accounts are created for the payer or payee, and (2) the funds need to be directly transferred or made available to the payee or a service provider acting on his/her behalf.

The second alternative's scope remains unclear.²⁹⁰ If interpreted broadly it could also include factoring and collection services, however not every type of collection and factoring are covered.²⁹¹ Decisive is whether a supervision by the ZAG is needed. With

²⁸⁵ Bafin Merkblatt, Hinweise zum ZAG, sub. sec. 2 f), official reasons BT-Drucksache 16/11613, p. 35

²⁸⁶ Ibid.

²⁸⁷ Casper/Terlau/Casper, ZAG, par.1, Rn. 67

²⁸⁸ Ibid., Rn. 68

²⁸⁹ Ibid.

²⁹⁰ Ibid. Rn. 73

²⁹¹ Ibid., Rn. 67, 73, Bafin Merkblatt, Hinweise zum ZAG, sub. sec. 2 f)

regards to payment services in the form of money remittance, it is the payer/payee who trusts that the payment service provider transfers or withdraws the funds in a correct and orderly fashion, however in the case of factoring or collection both the neutrality of cashless transfers and the typical collision of interests between payer and payment service provider are missing.²⁹² In addition to that the basis for negotiations is also completely different.²⁹³ It follows that recourse factoring as well as collection of claims should be taken out of the field of application of no. 6 alt. 2 by way of a teleological reduction.²⁹⁴ The reasoning is that if someone collects claims, the service provider moves to the camp (*in das Lager*) of the seller and does not act as a typical payment service provider anymore, s/he acts primarily in her/his own interest and not in the interest of the payment service user. It also follows from a cross reference to sec. 2 (2) RDG that mere collection of claims (*reines Inkasso*) remains within the field of application of no.6 alt. 2, however it cannot be considered money remittance anymore, if services are conducted that exceed the mere collection of claims, e.g. carrying out accounting, invoicing and the dunning process.²⁹⁵ Similarly the application of alt. 2 to factoring can be reasoned with an *argumentum e contrario* in relation to sec. 32 (6) KWG in connection with sec. 1 (1a) no. 9 ZAG, so that the collection of a transferred claim within the meaning of recourse factoring can fall within alt. 2.²⁹⁶ Thus the circumstances of each individual case need to be evaluated and the decision based on the analysis of whether the services, if looked at from an economic perspective, are intended to be payment processing services rather than financing the contractual partner.²⁹⁷

The platform operator is not involved in the cash flows regarding the loans from the credit project and thus cannot qualify as payment service provider within the meaning of the ZAG.

The associated entity however receives monies from the investors and transfers a corresponding amount to the bank. The associated entity therefore could conduct payment services according to sec. 1 (2) no. 6 ZAG if the transfer of the investor monies is

²⁹² Casper/Terlau/Casper, ZAG, par. 1, Rn. 76

²⁹³ Ibid.

²⁹⁴ Ibid.

²⁹⁵ Bafin, Merkblatt, Hinweise zum ZAG, sub. sec. 2 f)

²⁹⁶ Ibid.

²⁹⁷ Ibid.

conducted for the sole purpose of transferring a corresponding amount. The associated entity acquires the repayment claims from the bank and then sells them to the investors. It consequently receives a purchase price for the repayment claims and forwards a corresponding amount to the bank. However the associated entity receives and transfers the investors' funds in discharge of its own contractual payment claims vis-à-vis the bank and not merely in order to transfer a corresponding amount. Payments to investors are furthermore executed by the bank, rather than the associated entity. The associated entity consequently does not receive and transfer money for the sole purpose of transferring a corresponding amount and thus does not qualify as payment service institution within the meaning of the ZAG.

e) Statutory permission according to the RDG

The platform operator and/or associated entity could conduct debt collection services within the meaning of sec. 2 (2) RDG and thus be subject to a license requirement according to the RDG.

According to sec. 2 (2) RDG debt collection services, i.e. the collection of somebody else's claim or the collection of a claim that has been transferred in order to be collected, if the debt collection is being conducted as an independent activity (*Inkassodienstleistung*).

Thus it needs to be determined whether the platform operator and/or the associated entity conduct the collection of claims for somebody else's account as their own business activity.²⁹⁸ This would be the case if the claims are completely transferred to the purchaser, as s/he then assumes the full economic risk.²⁹⁹

The platform operator is not involved in the cash flow and therefore does not handle or collect any payments. The claims are managed by the bank vis-à-vis the investors. The platform operator merely assists, by conducting the servicing of the loans for the investors, i.e. by sending out dunning letters or offering refinancing strategies to the borrower during the first ninety days of a borrower's default, but is not involved in the

²⁹⁸ Kilian/Sabel/vom Stein, Das neue RDG, par. 6, Rn. 130

²⁹⁹ Krenzler/Offermann-Burckart, RDG, par. 2, Rn. 84

cancellation of the loan contract and the collection of money. The cancellation of the loan contract is only conducted by the bank as well as the sale and transfer of the contract to a collection agency (*Inkassounternehmen*), which will then collect the outstanding amount.

The bank transfers the claims to the associated entity which then transfers the claims on to the investors, however the claims are not transferred to the associated entity for the purpose of collection, but for the purpose of transferring them on to the respective investors as a service for the bank.

The platform operator could however conduct a legal service within the meaning of sec. 2 (1) RDG, by carrying out an individual activity for somebody else and which requires a legal analysis of the individual case. This would be the case if the individual activity is subject to a legal subsumption of the facts of the case³⁰⁰ and requires an analysis of whose interest is primarily exercised³⁰¹.

If a borrower comes into arrears the platform operator will, during the first ninety days of the borrower's default, send out payment reminders and subsequently a dunning letter or offer refinancing strategies. Thus it needs to be analysed whether this activity is an individual activity that requires a legal analysis and which is conducted for somebody else. Whether the activity is conducted for someone else is determined based on whether the activity is economically an activity carried out by the platform operator for herself or for someone else.³⁰² The platform operator acts as agent on behalf of the investors by servicing the loan and thus conducts the service for someone else. Consequently it needs to be determined whether that activity requires a legal analysis. A legal analysis is required for every specific question, which objectively requires a legal subsumption and specific legal knowledge;³⁰³ it is not the case if it is merely a general legal advice³⁰⁴ or if the legal analysis can also be easily and unambiguously conducted by a layman³⁰⁵. Whether a borrower repays his/her instalment on the due date is a question of fact, not a legal question, and can be determined by anyone who knows the due date. Furthermore

³⁰⁰ Krenzler/Krenzler, RDG, par. 2, Rn. 16

³⁰¹ Deckenbrock/Henssler/Deckenbrock/Henssler, RDG, par. 2, Rn. 23

³⁰² Franz, Das neue RDG7, p. 17

³⁰³ Deckenbrock/Henssler/ Deckenbrock/Henssler, RDG, par. 2, Rn. 33, BT-Drucksache 16/3655, p. 47

³⁰⁴ Ibid.

³⁰⁵ Kilian/Sabel/vom Stein, Das neue RDG, par. 3, Rn. 31

the sending out of payment reminders does not require a legal analysis, since this follows the dunning process as defined by the company and enforced on specific day past due dates. Hence, no legal analysis is required, so that no legal service is conducted by the platform operator.

Consequently the platform operator is not subject to a license requirement according to the RDG.

3. Summary

Direct peer-to-peer lending would require a banking license under German law. Therefore peer-to-peer platforms need to cooperate with a bank in order to conduct indirect peer-to-peer lending. The platform operator, that assists in the conclusion of a contract between the bank and the borrower, requires a license according to sec. 34c (1) no.2 GewO.³⁰⁶ The analysis has however also shown that the associated entity could be considered to conduct factoring according to sec. 1 (1a) 2 no. 9 KWG and thus would require a license according to sec. 31 (1) KWG, as stated above it remains to be seen how this will be assessed by Bafin in the future. Likewise if the platform operator or the associated entity were to conduct direct debit services they would conduct payment services within the meaning of sec. 1 (2) no. 2 ZAG in connection with no. 3 ZAG and thus require a license according to sec. 8 (1) ZAG.

II. Consumer protection

1. Consumer protection under German law

Sec. 491-512 BGB and sec. 655a-655e BGB are intended to regulate consumer protection in the credit market.³⁰⁷ The consumer borrower is faced with two risks: complex contractual frameworks and temptation.³⁰⁸ Credit agreements regulate a number of different parameters, which are not easily comparable and which are difficult to

³⁰⁶ The analysis is thus in line with Bafin's argumentation in: Bafin, Merkblatt, Hinweise zur Erlaubnispflicht der Betreiber und Nutzer einer internetbasierten Kreditvermittlungsplattform nach dem KWG

³⁰⁷ MüKoBGB/Bd. 4/Schürnbrand, sec. Vor § 491 BGB, Rn. 1

³⁰⁸ Ibid.

understand.³⁰⁹ Consequently it is difficult for consumers to compare competitors and get a market overview. Furthermore the borrower faces immediate temptation, since the amount of money will be made available instantly. This may lead to an underestimation or suppression of future payment obligations and hence to indebtedness.³¹⁰ This subsequently does not only have grave effects on the consumer himself, but also on the economy as a whole. The legislator therefore has created protection mechanisms for borrowers.

According to the Consumer Credit Directive, the terms of the credit agreement need to be transparent.³¹¹ As described above, the partner bank enters into a consumer loan agreement with the borrower and thus has to ensure that the terms of the credit agreement are transparent.

Sec. 491a BGB transforms art. 5 (pre-contractual information) and 6 (pre-contractual information requirements for certain credit agreements in the form of an overdraft facility and for certain specific credit agreements) of the Consumer Credit Directive (Directive 2008/48/EC on credit agreements for consumers (“**Consumer Credit Directive**”)) into German Law. Its application is further detailed in art. 247 of the Introductory Act to the German Civil Code (*Einführungsgesetz zum Bürgerlichen Gesetzbuch* – “**EGBGB**”).³¹²

Sec. 491a (1) BGB is designed as a pre-contractual obligation to provide information and as such requires a contractual obligation within the meaning of sec. 311 (2) BGB.³¹³ The different items of the information³¹⁴ as well as the sample Standard European Consumer Credit Information are regulated in art. 247 EGBGB.³¹⁵

Sec. 491a (2) BGB defines the borrowers’ right to request a copy of the draft credit agreement free of charge in addition to the standard information from the lender.³¹⁶ The draft agreement shall contain the intended content of the credit agreement.³¹⁷ The

³⁰⁹ Ibid.

³¹⁰ Ibid., cf. Financial crisis

³¹¹ Cf. Consumer Credit Directive

³¹² BT-Drucksache 16/11643, p. 78

³¹³ Ibid.

³¹⁴ Art. 5 (1), 6 (1) Consumer Credit Directive

³¹⁵ BT-Drucksache 16/11643, p. 78, zu Absatz 1

³¹⁶ Ibid., Art. 5 (4), 6 (6) Consumer Credit Directive

³¹⁷ BT-Drucksache 16/11643, p. 78, zu Absatz 2

borrower hence has the right to request this information from the partner bank as lender. However the borrower is not in direct contact with the partner bank, but rather the platform operator as intermediary. The credit agreement has to be drafted and provided by the partner bank, however the borrower will have to place his/ her request to the platform operator, which will provide the documents on behalf of the partner bank.

Sec. 491a (3) BGB requires that creditors and, where applicable credit intermediaries, provide adequate explanations to the consumer in relation to the terms of the contract, enabling him to assess whether the proposed credit agreement is adapted to his needs and to his financial situation.³¹⁸ The explanation needed is dependent on the complexity of the specific credit and needs to be given to the consumer in advance of the conclusion of the credit agreement as the result of the explanation is intended to be a support in the borrower's decision for or against the conclusion of the contract.³¹⁹ As the Consumer Credit Directive is intended to facilitate cross-border consumer credit agreements, the explanation does not have to be given in person, but via telephone or in written form.³²⁰ This introduces the codification of an obligation that under German law so far had not been codified.³²¹ Until now this obligation would have followed as accessory obligation (*Nebenpflicht*) from sec. 241 BGB. Consequently, the partner bank or the platform operator are under the obligation to provide adequate explanations to the borrower. The partner bank as creditor and party to the loan contract could be required to provide such explanations to the borrower as the information is directly linked to the concluded loan agreement. However, as described above, the platform operator as intermediary handles all actions and communication with regards to the conclusion of the loan agreement. The borrower uses the platform operator to issue a loan request, to secure investor funding and conclude a loan agreement with the partner bank. Hence the partner bank cannot provide such explanations to the consumer borrower. However the platform operator could be required to provide such adequate explanations to the consumer prior to the conclusion of the loan agreement. The platform operator performs a credit check of the borrower and assigns an interest rate based on the information provided by the borrower and on the basis of the SCHUFA score. The platform operator consequently has the

³¹⁸ Art. 5 (6) Consumer Credit Directive

³¹⁹ Ibid., BT-Drucksache 16/11643, p. 78, 79, zu Absatz 3

³²⁰ Ibid., p. 78, 79, zu Absatz 3

³²¹ Ibid., p. 78, zu Absatz 3

necessary information to provide the borrower with an adequate explanation to assess whether the proposed credit agreement is adapted to the borrower's needs and financial situation. Thus the platform operator is required to provide such explanations.

2. European guidelines on consumer protection

The Consumer Credit Directive intends to harmonise the internal market for consumer credits by creating a common framework in several key areas.³²² The consumers' confidence shall be ensured by offering a sufficient level of protection.³²³ The consumers shall be protected against unfair or misleading practices, in particular with respect to the disclosure of information by the creditors³²⁴ and shall be able to make an informed decision and to compare different offers³²⁵. Therefore they shall receive information in relation to the terms and costs of the loan in advance, so that they can consider them prior to the conclusion of the agreement.³²⁶

Following the argumentation above, the partner bank or the platform operator could be required to provide information in relation to the terms and costs of the loan, so the borrower can consider them prior to the conclusion of the agreement. Similarly to the line of reasoning above, the partner bank as party to the loan contract could be required to provide such information especially with regards to the interest rate of the loan. However the platform operator not only determines the interest rate of the loan for each borrower, but also claims a fee for the brokerage of the loan agreement, which is deducted from the loan amount. Consequently as intermediary, the platform operator is required to provide such information to the borrower.

³²² Directive 2008/48/EC, Introduction sec. 7, accessed on 04.03.2015, 1pm: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:133:0066:0092:EN:PDF>

³²³ Ibid., Introduction, sec. 8

³²⁴ Ibid., Introduction, sec. 18

³²⁵ BeckOK BGB/Möller, BGB, par. 491a, Rn. 2

³²⁶ Directive 2008/48/EC, Introduction sec. 7, accessed on 04.03.2015, 1pm: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:133:0066:0092:EN:PDF>, Introduction, sec. 19

B. Regulation of peer-to-peer platforms in the United Kingdom (UK)

I. Regulation of the consumer lending in relation to peer-to-peer lending

1. General principles

In the UK, the regulation of the consumer credit market has been transferred from the Office of Fair Trading to the Financial Conduct Authority (“FCA”) on April 1st, 2014.³²⁷ Following a consultation process, a new regulation was put in place by the newly appointed FCA in order to regulate loan-based crowdfunding platforms.³²⁸ The regulation was designed to secure an appropriate degree of consumer protection and promote effective competition in the interest of the consumer.³²⁹ The regulation came into force on April 1st, 2014, subject to certain transitional rules. A first review of the regulatory framework was conducted at the end of 2014 and a complete post-implementation review of the regulatory framework as well as the underlying crowdfunding market was conducted in 2016.

Whether companies are permitted to carry on financial activities is regulated in The Financial Services and Markets Act 2000 (“FSMA”), which has been amended by the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (“**RAO 2001**”) and Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 2) Order 2013 (“**RAO 2013**”). The Act sets forth the regulated activities that require permission from the FCA. According to sec. 139 FSMA a guidance manual, the FCA Handbook, is issued. The Handbook contains the FCA’s legislative and other provisions made under the FSMA.³³⁰ It contains the complete record of FCA legal instruments and presents changes in a single, consolidated view. It consists of several rulebooks, some of which qualify as rules, i.e. binding obligations, or guidance, i.e. to explain the implications of other provisions.³³¹ The Perimeter Guidance Manual (“**PERG**”), as part of the FCA Handbook, constitutes a guidance in relation to the FSMA. According to sec. 1.3.1G PERG, the guidance represents the FCA’s views, but does not

³²⁷ FCA, PS14/4, p.6

³²⁸ Ibid.

³²⁹ Ibid.

³³⁰ FCA, An introduction to the Handbook, p. 3

³³¹ Ibid., p. 5, 11

bind the courts. However, if a person acts in line with the guidance, the FCA will proceed as if the person complied with all aspects of the requirement to which PERG relates.

2. Legal analysis

The peer-to-peer platform engages in different activities, which include among others, origination of loans, collection of payments from investors, the sale and transfer of repayment claims as well as the servicing of defaulted payments.

a) Basis for the analysis

The analysis, which license requirements apply, will be conducted with regards to direct peer-to-peer lending as described above, in relation to the activities carried out by the platform operator. Due to the introduction of a new regulation, dedicated to regulate loan-based crowdfunding platforms, indirect peer-to-peer lending, as conducted in Germany, will not be subject to the analysis as the objective of this dissertation is to analyse the regulation of peer-to-peer platforms.

b) Statutory permission under the FCA

The conduct of regulated activities requires permission from the FCA. A regulated activity is defined in sec. 22 FSMA in combination with sec. 1.2.1G(2) PERG as an activity, that is specified in the RAO 2013, carried on by way of business in relation to one or more of the investments specified in the RAO 2013. Whether an activity qualifies as regulated activity subsequently is dependent on four prerequisites: First, a regulated activity needs to be conducted, i.e. an activity that is regulated under the act, second the activity needs to be carried out by way of business, third, a link between the activity and the UK needs to exist, fourth the investments must come within the scope of the system of regulation under the act. This will be examined in further detail below with regards to direct peer-to-peer lending.

aa) Regulated activity

First it will be examined which regulated activity is conducted by the platform operator.

(1) Accepting deposits

The platform operator could conduct the regulated activity of accepting deposits according to art. 5 RAO 2001 in connection with sec. 2.7.2 PERG. The term deposit is defined in art. 5(2) RAO 2001, as a sum of money, other than one excluded by any of art. 6 to 9, paid on terms under which it will be repaid, with or without interest or a premium, and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it, and which are not referable to the provision of property (other than currency) or services or the giving of security. Accepting deposits is defined in art. 5 RAO 2001, as a specified kind of activity if money received by way of deposit is lent to others or any other activity of the person accepting the deposit is financed, wholly or to a material extent, out of the capital of or interest on money received by way of deposit.

The following definition of deposit will be used for the subsequent analysis: a sum of money paid on terms under which it will be repaid, with or without interest, at a time agreed by the person making the payment and the person receiving it. Consequently the platform operator would have to receive a sum of money, which has to be repaid with or without interest and which is lent to others.

The platform operator offers investors the possibility to invest in consumer credits and borrowers the possibility to apply for loans. In order to fund the borrowers' loans, investors have to transfer the amount of their respective commitment to the platform operator, which then pools the money with regards to the respective loans and hence issues the loans to the borrowers. The platform operator thus receives sums of money from the investors. These sums of money are following lent to others, i.e. borrowers. Whether the platform operator or the investor ultimately acts a lender of record can be left unanswered here, as it is not decisive for the analysis of whether the platform operator accepts deposits, since the definition merely requires that the money received need to be lent to others. Furthermore the money has to be repaid to the investors. However the question arises whether the money is repaid with or without interest. The investors do receive interest on the repayment, but this interest is paid by the respective borrower on top of his/her repayments. The platform operator consequently merely transfers the repayment plus interest on to the investor. Since a deposit exists regardless of whether

the money is repaid with or without interest, this is not decisive. A sum of money is paid by the investors to the platform operator in order to fund borrowers' loans on terms, that the money will be repaid with interest at a time agreed by the investors and the platform operator, i.e. usually in instalments over the lifetime of the loan. The platform operator consequently accepts deposits and hence conducts a regulated activity.

(2) Credit broking

The platform operator could furthermore conduct credit broking according to sec. 36A FSMA in connection with sec. 2.7.7E PERG. Credit broking is defined in sec. 36A (1) FSMA. Six activities can qualify as credit broking. These are: (a) effecting an introduction of an individual who wishes to enter into a credit agreement to another person, with a view to that person entering as lender into a credit agreement by way of business; (b) effecting an introduction of an individual who wishes to enter into a consumer hire agreement to another person, with a view to that person entering as owner into a consumer hire agreement by way of business (except where the exemption relating to the supply of essential services would apply to the consumer hire agreement); (c) effecting an introduction of an individual who wishes to enter into a credit agreement or a consumer hire agreement to a person who carries on an activity in (1) or (2) by way of business; (d) presenting or offering an agreement which would (if entered into) be a credit agreement; (e) assisting an individual by undertaking preparatory work with a view to that person entering into a credit agreement; (f) entering into a credit agreement on behalf of a lender. Thus it needs to be analysed whether the platform operator conducts any of those activities.

The platform operator could be affecting an introduction of an individual who wishes to enter into a credit agreement, i.e. a borrower to another person, a lender, with a view to that person entering as lender into a credit agreement by way of business. This could be the case if the platform operator merely acted as operator of a platform that facilitated the introduction of persons in search of loans and persons that wish to invest money into consumer loans, i.e. act as lenders. However the lenders would have to act by way of business. Whether an activity is carried out by way of business is a question of judgement, that is dependent on several factors, inter alia, the degree of continuity, the existence of a commercial element, the scale of the activity, the proportion which the activity bears to

the other activities carried on by the same person, natural or legal, but which is not regulated, and the nature of the activity itself, according to sec. 2.3.2 PERG. If the platform operator conducts any of the other activities, this does not have to be decided. Nevertheless with regards to natural persons acting as investors it is doubtful that they would act by way of business. It is possible that they would act as lender through a peer-to-peer platform on an ongoing basis, but it is doubtful that such an activity would bear a larger part with regards to other activities carried out by that person. This could only be the case if the person acted commercially and on a scale that would give the impression of a professional activity. Any natural person does however only have limited funds and hence cannot conduct such an activity on a commercial scale. Legal persons on the other hand could specialize in such an activity.

The platform operator could be presenting or offering an agreement, which if entered into, would be a credit agreement. The platform operator's business is aimed at granting loans to borrowers funded with investors' money. The platform operator therefore presents or offers borrowers to enter into a credit agreement.

Additionally the platform operator could be assisting an individual, i.e. a natural person, by undertaking preparatory work with a view to that person entering into a credit agreement. The platform operator does conduct preparatory work in relation to the conclusion of a credit agreement. It conducts a credit assessment of the borrower, assesses whether the borrower has the capacity to repay the requested loan and prepares the credit agreement. It consequently assists the borrower in entering into a credit agreement. However it is not clear whether this activity can also be fulfilled if the person undertaking the preparatory work is actually the lender of record, as this could constitute a conflict of interest.

Furthermore the platform operator could be entering into a credit agreement on behalf of the lenders.

The open questions however do not have to be decided here, since according to sec. 36A (2) FSMA, para. (1) does not apply if the activity qualifies as operating an electronic system in relation to lending according to sec. 36H FSMA. Hence it shall be investigated whether peer-to-peer lending qualifies as such.

(3) Operating an electronic system in relation to lending

According to art. 36H (1) FSMA in connection with sec. 2.7.7H PERG operating an electronic system in relation to lending will be fulfilled if an electronic system enables the operator to facilitate other persons becoming lender and borrower under an article 36H agreement. An article 36H agreement is defined in para. (4) as an agreement between one person, the borrower, and another person, the lender, by which the lender provides the borrower with credit and either of the following conditions is fulfilled: the lender or the borrower is an individual, and if the borrower is an individual the amount of the credit provided is less than or equal to 25,000 pounds or the agreement is not entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower. The platform operator or the investor could enter into an agreement with the borrower regarding the issuance of a loan by the lender to the borrower. In order to further qualify as article 36H agreement either the lender or the borrower would have to be an individual. With regards to consumer credits, the borrower has to be an individual. Consequently the credit provided by the lender cannot exceed 25,000 pounds or the borrower needs to enter into the agreement privately and not in relation to a business.

The following requirements furthermore need to be fulfilled in order to qualify as the activity of operating an electronic system in relation to lending according to sec. 2.7.7H(2) PERG. First, the system must be capable of determining which agreements would be made available to the other persons according to sec. 2.7.7H(2)(a) PERG. The electronic system, e.g. the peer-to-peer platform is programmed to identify whether a customer is registering as borrower or as investor and which agreements apply to them respectively.

Second, according to sec. 2.7.7H(2)(b) PERG, the operator or an entity associated with the operator receives payments in respect of interest or capital or both due under the article 36H agreement from the borrower, and makes payments in respect of interest or capital or both due under the article 36H agreement to the investor. The borrowers have to repay their loans in instalments (usually monthly) with additional interest. The money usually is transferred to the platform operator itself or it may be transferred to an

associated entity.³³² Following the money plus interest is transferred to the respective investors who participated in the loan.

Third, the operator or its associated entity or another entity appointed or directed by the operator takes steps to procure the payment of debt under the article 36H agreement and exercises or enforces rights under the article 36H agreement on behalf of the investor, according to sec. 2.7.7H(2)(c) PERG. If the borrower comes into arrears the platform operator usually conducts the initial collection services, i.e. it sends out payment reminders or dunning letters and hence takes steps to procure payment of debt under the agreement and exercises or enforces the investors' rights under the agreement on their behalf. After a certain period of time a collection agency usually takes over to enforce the rights of the investors on their behalf and thus takes steps to procure the payment.

Since all the conditions are met, a platform operator that conducts peer-to-peer lending consequently operates an electronic system in relation to lending and thus conducts a regulated activity.

According to sec. 2.7.7H(7) PERG the following activities are also caught by operating an electronic system in relation to lending if carried out by the operator: conducting a credit assessment of the borrower and publishing certain information in relation to that in order to assist a potential lender to determine whether to provide a credit to that person (sec. 2.7.7H(7)(b) PERG), performing actions or enforcing rights under the article 36H agreement on behalf of the lender (sec. 2.7.7H(7)(c) PERG), requesting a credit report, i.e. financial information, on a borrower from a credit bureau (sec. 2.7.7H(7)(e) PERG), taking further steps to ascertain the information from the report (sec. 2.7.7H(7)(f) PERG), or taking further steps to secure the correction of, the omission of anything from or the making of any other kind of modification of such information (sec. 2.7.7H(7)(g) PERG). These examples summarize the main activities performed by platform operators and hence should fall within the scope of a regulation aimed at peer-to-peer lending platforms.

³³² Cf. Legal analysis of Germany

bb) By way of business

In order to qualify as a regulated activity that requires permission from the FCA, the activity needs to be carried on by way of business according to sec. 2.3.2 PERG. Whether an activity is carried on by way of business is a question of judgement, that is dependent on several factors, inter alia, the degree of continuity, the existence of a commercial element, the scale of the activity, the proportion which the activity bears to the other activities carried on by the same person, but which is not regulated and the nature of the activity itself.

The platform operator could conduct the regulated activities of accepting of credits and operating of an electronic system in relation to lending by way of business. Both activities are carried on and are intended to be carried on continuously, i.e. long-term, by the platform operator. Furthermore a commercial element needs to exist. A commercial element is inferred if the activity is conducted in the course of business, i.e. if it is a permanent activity with the intent to realise a profit.³³³ The platform operator conducts the business of operating a peer-to-peer lending platform, both activities, accepting deposits and operating an electronic system in relation to lending, are therefore carried on in the course of business as they are the very business of the platform operator. Moreover the scale of the activity and the proportion to other activities are important. The business of a peer-to-peer lending platform essentially is the provision of a platform which enables borrowers and investors to borrow and lend money, to assess the creditworthiness of the borrower and to make that information available to the investors and to assist both parties throughout that process. Its main business should be seen in the granting of credits. In order to grant those credits, they have to be financed. This is ensured through the investments of investors, who transfer the respective money to the platform operator, which hence accepts deposits. Following the money is granted to borrowers, i.e. a loan agreement is concluded. This shows that the main activities carried out by a platform operator are the regulated activities. The other activities merely are supporting activities that enable the platform operator to grant loans and accept deposits and to operate such an electronic system.

³³³ This definition has been derived from a reference to the definition of commercial business according to the GewO as well as a reference to the definition of “non-commercial agreement” in the FCA Glossary as “a credit agreement or a consumer hire agreement not made by the lender in the course of a business carried on by the lender or owner”

The regulated activities are consequently carried out by way of business.

cc) Link between the activities and the UK

The activities need to be carried on 'in the UK' according to sec. 19 FSMA in connection with sec. 2.4.1 PERG. The meaning of 'in the UK' is further specified and extended in sec. 418 FSMA to five cases: (1) a UK-based person carries on a regulated activity in another EEA state exercising rights under a single market directive, (2) the marketing in another EEA state of a UK-based collective investment scheme, (3) a regulated activity is carried on by a UK-based person and the day-to-day management of the activity is the responsibility of an establishment in the UK, (4) a regulated activity is carried on by a person not based in the UK, but from an establishment in the UK, and (5) an electronic commerce activity is carried on from an establishment in the UK in another EEA state.

Several peer-to-peer platforms require investors and borrowers to be UK-based companies, i.e. having its registered office in the UK, English nationals or at least resident in the UK, having a UK bank account. They consequently do not offer cross-border activities, but their customers need to be based in the UK, in order for them to carry out their activities in the UK. Under these circumstances a platform operator consequently carries on its activities in the UK.

Should a platform however allow other nationals to use its services it would have to ensure that any of the five cases according to sec. 418 FSMA are fulfilled.

dd) Investments and activities under the Act

Additionally the investments must come within the scope of the system of the regulation under the FSMA according to sec. 2.5.1 in connection with sec. 2.6 PERG and the activities carried on in relation to those specified investments need to be regulated under the FSMA according to sec. 2.5.1 in connection with sec. 2.7 PERG.

Sec. 2.6 PERG defines the specified investments, that require permission from the FCA. They include, inter alia, deposits (2.6.2 PERG), electronic money (2.6.4A PERG), rights under a credit agreement and article 36H agreement (2.6.30 PERG). Rights under an article 36H agreement refers to the regulated activity of operating an electronic system in

relation to lending according to art. 36H FSMA, under which an article 36H agreement may be concluded.

Sec. 2.7 PERG outlines the various regulated activities, including inter alia, accepting deposits (2.7.2 PERG), credit broking (2.7.7E PERG) and operating an electronic system in relation to lending (2.7.7H PERG). As analysed above a platform operator conducts the activities of accepting deposits and operating an electronic system in relation to lending and thus carries on activities that are regulated under the FSMA in relation to investments that come within the system of regulation under the FSMA.

3. Summary

Peer-to-peer lending in the UK is regulated since 2014. A special regulated activity, operating an electronic system in relation to lending, was introduced in relation to peer-to-peer lending. It captures the main business of such platforms and ensures they are regulated under the FSMA and thus need to receive permission in order to conduct their business.

II. Consumer protection

One of the FCA's main objectives is to ensure the fair treatment of consumers by any business and that market integrity and competition are not adversely affected.³³⁴

Consumer protection rules are set out in the Consumer Credit sourcebook ("CONC"). It is a specialist sourcebook for credit-related regulated activities (sec. 1.1.1 CONC), that is designed to set out detailed obligations (sec. 1.1.2 CONC). Credit-related regulated activities are those specified in part 2 or 3A of the RAO 2001 and include operating an electronic system in relation to lending regarding a (prospective) borrower under a peer-to-peer agreement.³³⁵ A peer-to-peer agreement is defined as an agreement in accordance with art. 36H RAO 2013 by which one person provides another person with credit and the operator of the electronic system does not provide the credit, assume rights (by

³³⁴ FCA, Guide for consumer credit firms, p. 4

³³⁵ FCA, Glossary

assignment or operation of law) of a person who provided the credit.³³⁶ Additionally the borrower needs to be an individual and the lender either provides a credit of less than 25,000 pounds or the agreement is not entered into or intended to be carried on predominantly for business purposes.³³⁷ Credit is defined as a cash loan.³³⁸ As described above the platform operator conducts the activity of operating an electronic system in relation to lending, the loan is financed by the investor and provided by either the platform operator or the investor in the sense that either party can be the counterpart to the loan agreement. The loan usually does not exceed 25,000 pounds and is concluded with a borrower who is an individual. Thus the CONC applies to the activities of peer-to-peer platforms.

It includes rules on inter alia, conduct of business, financial promotions and communications with customers, pre-contractual requirements, credit assessments, post-contractual requirements as well as on arrears, default and recovery. Some of these rules will be investigated in further detail below.

1. General principles

General principles for business are set forth in sec. 1.1.4 CONC. These include, inter alia, the following requirements for firms:

- Paying due regard to the interests of its customers and treat them fairly;
- Paying due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading;
- Taking reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment;
- Arranging adequate protection for clients' assets when it is responsible for them.

These general principles target the objective to protect consumers and to treat them fairly. Specific principles that are intended to secure those objectives will be analysed in further detail below.

³³⁶ Ibid.

³³⁷ Ibid.

³³⁸ Ibid.

2. Credit references

According to sec. 2.4 CONC a lender has to disclose the name and address of credit reference agencies to the borrower. This should be done before the conclusion of an agreement and may be included in the terms and conditions. In order to communicate the information clearly and in a fair manner it could also be published on the platform operator's website, e.g. in the FAQ section or be given to the borrower during the application process. Furthermore it would be fair to also inform the borrower about the information that is requested from the credit bureau as well as the implications this request might have for the borrower.

3. Financial promotions and communications with customers

a) Application

Chapter 3 applies to any firm and its communication with a customer in relation to a credit agreement (sec. 3.1.3(1) CONC), its communication or approval for communication of a financial promotion in relation to a credit agreement (sec. 3.1.3(2) CONC) and a communication with a borrower or prospective borrower as well as the communication or approval of communication of a financial promotion in relation to operating an electronic system in relation to lending (sec. 3.1.3(5) and 3.1.3(6) CONC).³³⁹

Guidance on the meaning of the word 'communicate' can be found in sec. 8.6 PERG. The FCA takes the view, that a person is communicating when it gives material to the recipient or when he is responsible for transmitting the material on behalf of another person in certain circumstances. Not only the originators of information fall under the definition, but the FCA also considers intermediaries who redistribute another person's communication to be communicating or causing communication (sec. 8.6.2 PERG). The operators of peer-to-peer lending platforms distribute information as well as marketing material directly to the recipient. Furthermore they publish information with regards to borrowers on their website and hence redistribute the borrowers' information to potential prospective investors.

³³⁹ Ibid.

Financial promotion is defined in the FCA's Glossary, as any invitation or inducement to engage in an investment activity that is communicated in the course of business.³⁴⁰ To engage in an investment activity is defined as entering or offering to enter into an agreement the making or performance of which by either party constitutes a controlled activity, which includes accepting deposits and operating an electronic system in relation to lending.³⁴¹ The offering to enter as well as the entering into an agreement under the activity of operating an electronic system in relation to lending consequently qualifies as financial promotion and hence peer-to-peer platforms engage in financial promotions.

The rules that apply in relation to communication and financial promotions will now be regarded in further detail.

b) The clear, fair and not misleading rule

Any communication or financial promotion must be clear, fair and not misleading according to sec. 3.3.1 CONC. This means that each communication and each financial promotion needs to fulfil the following requirements: it needs to be accurate and balanced, it may not emphasize any potential benefits of a product or service while also indicating any relevant risks, it needs to be presented in a way, so that it can be understood by the average member of the group it is addressed to, it may not disguise, omit, diminish or obscure important information or warnings and contrasts and comparisons need to be presented in a fair and balanced way. General requirements, according to sec. 3.3.2 CONC, furthermore include the use of plain and intelligible language, the use of the firm's trading name, internet address or logo and the name of the communicating person. Moreover it may not be implied that a credit is available irrespective of the customer's financial circumstances (sec. 3.3.3 CONC). Sec. 3.3.10 CONC also includes examples of practices that will be likely to violate that rule. The section furthermore states examples of practices that will be regarded as contravening the rule (sec. 3.3.10 CONC).

c) Financial promotion about credit agreements not secured on land

Sec. 3.5 CONC applies to financial promotions in relation to consumer credit lending. Consumer credit lending, in accordance with art. 60B RAO 2013, is defined as entering

³⁴⁰ Ibid. and cf. 8.3.2 PERG

³⁴¹ Ibid.

into a regulated agreement as lender or exercising, or having the right to exercise, the lender's rights and duties under a regulated credit agreement.³⁴² Credit agreement according to art. 60B(3) RAO 2013 is an agreement between an individual as recipient of credit and another person, which provides a credit of any amount.

The question that needs to be clarified here in order to determine whether the rules apply to the platform operator is, whether the platform operator provides the credit or the investor. The means, i.e. the monetary funding of the credit, are supplied by the investors. The investors could also act as lenders and enter into a credit agreement with the respective borrower. However the platform operator could also provide the credit, since the origin of the financial means should be irrelevant. A bank in comparison is also regarded as providing the credit even though the means for the credit are taken from investor deposits.³⁴³ If the platform operator therefore enters into the agreement with the borrower and transfers the loan amount to the borrower the platform operator should be regarded as providing the credit, regardless of whether the credit is financed by own means of the platform operator or money received from investors, that want to fund the respective credit.

Consequently if the platform operator enters into the contract with the borrower and transfers the loan amount to the borrower the rules with regards to financial promotions about credit agreements not secured on land should be applicable.

aa) Content of financial promotions

If a financial promotion includes information on or indicates the interest rate or cost of the credit, whether represented as a specific sum or as a percentage of a specified amount, the financial promotion needs to fulfil certain requirements according to sec. 3.5.3(1) CONC, which include inter alia: the inclusion of a representative example, a postal address of the person making the financial promotion.

Exceptions exist according to sec. 3.5.3(3) CONC in relation to financial promotions communicated by means of television or radio.

³⁴² FCA, Glossary

³⁴³ See above for more information

According to sec. 3.5.4 CONC, interest rates can be shown as daily, monthly or annual interest rates, including annual percentage rates (APR). Amounts in relation to costs should include any fees or charges as well as the repayment of the credit (where it includes interest or other charges).

bb) Representative example

Specific requirements apply to the depiction of a representative example, sec. 3.5.5 CONC. According to subsection (1) it must include the interest rate, whether it is fixed or variable or both, expressed as a fixed or variable percentage applied on an annual basis to the amount of credit, the nature and amount of any other charge included in the total charge for credit, i.e. the true cost of the credit³⁴⁴, the total amount of the credit, i.e. the total sum made available³⁴⁵, the representative APR, the duration of the agreement, the total amount payable, i.e. the total charge for the credit, meaning the true cost of the credit provided, plus the total amount of credit advanced³⁴⁶, and the amount of each repayment. The information that is communicated must be reasonably expected at the date the financial promotion is made according to subsection (2).

The information required by subsection (1) has to be presented together with each item given equal prominence, it has to be clear, concise and prominent, accompanied by the words ‘representative example’ (cf. sec. 3.5.5(5) CONC).

Annual percentage rates shall be shown as percentage (%APR), if subject to change it must be accompanied by the term ‘variable’ and the representative annual percentage rate must include the term ‘representative’, according to sec. 3.5.9 CONC.

4. Pre-contractual requirements

Ch. 4 CONC outlines the pre-contractual requirements, that have to be fulfilled by firms.

³⁴⁴ Ibid.

³⁴⁵ Ibid.

³⁴⁶ Ibid.

Furthermore specific pre-contractual requirements apply in relation to peer-to-peer agreements, according to sec. 4.3.3A CONC. Fees, payable by the borrower to the operator of an electronic system in relation to lending, must be agreed between the borrower and the operator and the agreement must be recorded in writing or other durable medium, before the peer-to-peer agreement is entered into (subsection (2)).

Furthermore before a peer-to-peer agreement is concluded, the operator must give adequate explanations according to sec. 4.3.4 CONC, which include, inter alia, features, which may make the credit to be provided unsuitable for particular types of use, the amount that the borrower has to pay periodically and the total amount under the agreement, if it can be determined, the features of the agreement which may operate in a manner that would have a significant adverse effect on the borrower in a way he is unlikely to foresee as well as the consequences arising for a borrower from the failure to make due payments in time, including legal proceedings and the effect of any right of withdrawal from the agreement and how and when this right may be exercised.

5. Creditworthiness assessment

Ch. 5 CONC sets out rules in relation to a creditworthiness assessment of the borrower.

According to sec. 5.2.1 CONC, the borrower's creditworthiness of a borrower needs to be assessed before the conclusion of a contract. Such an assessment shall be based not only on information provided by the customer, but credit bureaus shall also be consulted (subsection (3)).

The firm has to assess whether the commitments under the agreement may adversely impact the customer's financial situation, taking into account the information, which the firm is aware of at the time the agreement is concluded (sec. 5.2.2 CONC).

The creditworthiness assessment shall be based on the following factors according to sec. 5.2.3 CONC: the type, amount and cost of the credit, the borrower's financial position at the time of the loan application, the customer's credit history, including indications that he is experiencing or has experienced financial difficulties, any existing or future financial commitments, any future changes in circumstances which could be reasonably

expected to have a significant financial adverse impact on the customer and the vulnerability of the customer, in particular with regards to his mental capacity. However not all of these factors have to be considered in every assessment. Rather a firm should consider what is appropriate in the particular circumstances (sec. 5.2.4 CONC) and with regards to the potential risks to the customer.

The firm shall also consider different types and sources of information according to sec. 5.2.4(3) CONC, which include its record of previous dealings, evidence of income and expenditure, a credit score as well as a credit bureau report and information provided by the customer.

A creditworthiness assessment shall however not only take into account the customer's ability to repay the credit, but should also assess the customer's ability to meet repayments in a sustainable manner without the risk of the customer incurring financial difficulties or experiencing significant adverse consequences (sec. 5.3.1(1), (2) CONC).

6. Post-contractual requirements

Post-contractual requirements include, inter alia, the monitoring of the customer's repayment record and take appropriate action if there are signs of actual or possible repayment difficulties according to sec. 6.7.1 CONC as well as rules on refinancing. Refinancing according to sec. 6.7.11 CONC means to extend or purport to extend the period over which the repayments are made by the customer.

7. Arrears, default and recovery

According to sec. 7.2.1 CONC, a firm must establish and implement clear, effective and appropriate policies and procedures for dealing with customers whose accounts fall into arrears and the fair and appropriate treatment of customers who the firm understands or reasonably suspects to be particularly vulnerable.

Special rules apply according to sec. 7.17 CONC in relation the notice of sums in arrears under peer-to-peer agreements for fixed-sum credits in relation to the operator of an electronic system in relation to lending. Given the requirements under sec. 7.17.3 CONC

are fulfilled, the firm must within a period of fourteen days, beginning with the day on which the conditions are satisfied give the borrower a notice (sec. 7.17.4(1) CONC). The notice shall, according to sec. 7.17.7 CONC contain the information that the borrower is behind with the sums payable under the agreement, an encouragement to discuss the state of his account, the date, the address and contact details of the firm as well as according to sec. 7.17.8 CONC, the amount of the sums due and the date on which the sums became due.. Furthermore concrete statements that may be used are listed. The firm must then give further notices at intervals of no more than six months (sec. 7.17.4(2) CONC). The firm may stop giving notices, when the borrower ceases to be in arrears or a judgement is given in relation to the sum that is required to be paid by the borrower under the agreement (sec. 7.17.5 CONC).

C. Regulation of peer-to-peer platforms in Sweden

I. Regulation of consumer lending in relation to peer-to-peer lending

1. General principles

First will be investigated how lending is regulated in Sweden and which kind of financial intermediaries are allowed to grant loans. Subsequently it will be explored which license requirements apply to peer-to-peer lending.

The conduct of business in financial services is authorised, supervised and monitored by the Swedish Financial Supervisory Authority (*Finansinspektionen* – “SFSA”). Operations that involve the offering of financial services need to be authorised by the SFSA and need to be conducted in accordance with the regulations and general guidelines, Finansinspektionen’s regulatory code, (*Finansinspektionens författningssamling* – “FFFS”) issued by the SFSA.³⁴⁷

Banking and financing business are defined in the Swedish Banking and Financing Business Act (*Sw. lag (2004:297) om bank- och finansieringsörelse*) (the “BFB Act”).

³⁴⁷ SFSA, What we do

Both the conduct of banking and financing business require a license according to ch. 2 sec. 1 BFB Act³⁴⁸.

The conduct of payment services is regulated in the Swedish Payment Services Act (*lag. (2010:751) om betaltjänster*) (the “**PS Act**”), implementing the PSD and includes, inter alia, money remittance services and requires a payment institution license from the

2. Legal analysis

The platform operator could engage in different activities, either direct peer-to-peer lending, which includes among others the granting of loans, or indirect peer-to-peer lending, i.e. the mediation of loans. This will be analysed in further detail below.

a) Direct peer-to-peer lending

In order to conduct direct peer-to-peer lending, the platform operator would require permission from the SFSA under a credit market company license (“**CMC license**”). The platform operator would need to conduct banking or financing business according to ch. 1 sec. 3, 4 BFB Act.³⁴⁹

aa) Banking business according to the BFB Act

Banking business pursuant to ch. 1 sec. 3 BFB Act is defined as payment services via general payment systems and the receipt of funds after the notice is available to the creditor within thirty (30) days.

General payment systems are defined as systems for the forwarding of payments from several payers who are not associated with each other, which are otherwise intended to reach several ultimate payees, who are not associated with each other.³⁵⁰ In order to qualify as general payment systems a large number of payers and payees respectively need to be involved.³⁵¹

³⁴⁸ Ibid.

³⁴⁹ Ibid.

³⁵⁰ Interview, Emma Stuart-Beck

³⁵¹ Ibid.

Receipt of funds should be interpreted broadly and not considered only to encompass ‘normal deposits’, which are defined in the Swedish Act on Deposit Guarantee (Sw. *lag* (1995:1571) *om insättningsgaranti*) as a balance which is in relation to a deposit.³⁵² The key is that the funds received must be made available to the creditor within thirty (30) days following termination. Consequently, regular deposit taking, issuing of certain types of bonds and funds which are made available to the bank under other types of contracts, should be considered as receipt of funds pursuant to the BFB Act, while the form or the name in which the funds are made available to the bank are not relevant.³⁵³

The platform operator receives money from investors and forwards this money to the borrowers, i.e. it collects money from several investors and forwards this money to one respective borrower. It consequently merely handles money transfers from individual investors and to individual borrowers. Although the users are not associated with each other, it does not forward payments from and to a large number of customers. Therefore it does not operate general payment systems.

The platform operator could however conduct payment services. Payment services are defined in art. 4 no. 3 in connection with the Annex to the PSD as:

- (1) Services enabling cash to be placed on a payment account as well as all the operations required for operating a payment account;
- (2) Services enabling cash withdrawals from a payment account as well as all the operations required for operating a payment account;
- (3) Execution of payment transactions, including transfers of funds on a payment account with the user's payment service provider or with another payment service provider:
 - execution of direct debits, including one-off direct debits;
 - execution of payment transactions through a payment card or a similar device; and
 - execution of credit transfers, including standing orders;

³⁵² Ibid.

³⁵³ Ibid.

- (4) Execution of payment transactions where the funds are covered by a credit line for a payment service user:
- execution of direct debits, including one-off direct debits;
 - execution of payment transactions through a payment card or a similar device; and
 - execution of credit transfers, including standing orders;
- (5) Issuing and/or acquiring of payment instruments;
- (6) Money remittance; and
- (7) Execution of payment transactions where the consent of the payer to execute a payment transaction is given by means of any telecommunication, digital or IT device and the payment is made to the telecommunication, IT system or network operator, acting only as an intermediary between the payment service user and the supplier of the goods and services.

If the platform operator were to establish an own account system in order to receive and forward the borrowers' and investors' payments, the platform operator could operate a payment account as described in numbers (1) and (2) above. Under that circumstance the platform operator would conduct banking business. However, if the platform operator did not establish an own account system, but open an account with a Swedish bank and establish virtual sub-accounts for users or offer users to directly open accounts at the partner bank, it hence would not conduct any of the operations in relation to payment accounts ((1), (2)). Users would then have to transfer money to the platform operator and the platform operator would transfer the money to individual users, but would not conduct any payment transactions, as described under numbers (3), (4) and (5) above. Neither will the platform operator issue or acquire payment instruments, nor conduct money remittance.

Consequently, under the assumption that the platform operator does not establish an own account system,³⁵⁴ it does not conduct banking business. Thus it needs to be investigated whether the platform operator conducts financing business and hence is subject to a CMC license.

³⁵⁴ Similar to the set-up in Germany: the platform operator likewise does not establish an own account system but offers investors to open accounts at its partner bank.

bb) Financing business according to the BFB Act

Financing business pursuant to ch. 1 sec. 4 BFB Act is defined as accepting repayable funds from the general public and to grant loans, provide guarantees for loans or for financing purposes, to grant rights of use in personal property (leasing).

In relation to financing business, repayable funds are defined as funds which are made available to the creditor within one (1) year following termination.³⁵⁵ The term general public is not defined in the BFB Act. It should be interpreted very broadly and includes inter alia, private individuals and non-regulated entities.³⁵⁶ It is however possible to argue that financial institutions (e.g. banks, insurance companies and credit market companies) are not considered part of the public.³⁵⁷ Granting of loans is not explicitly defined in the BFB Act, it should however be interpreted to include all arrangements where a credit is given.³⁵⁸ The platform operator thus has to fulfil two requirements: (1) to accept repayable funds from the public, i.e. not from financial institutions, and (2) to grant loans.

(1) Accepting repayable funds from the public

The first requirement is to accept repayable funds from the public, which essentially means, that the platform would have to take deposits.³⁵⁹

The platform operator could fulfil this requirement by accepting funds from investors in order to fund the borrowers' loan projects (similar to the process described above for Germany). Investors would have to register on the platform and transfer money to a bank account held by the platform operator which has been designated for investor monies and could then start funding credit projects. The platform operator would enter into investor agreements with each investor participating in the relevant credit project regarding the sale and transfer of pro rata shares of the loans (net of a service fee). Each investor agreement would be subject to the condition precedent that the platform operator has

³⁵⁵ Interview, Emma Stuart-Beck

³⁵⁶ Newsletter Banking and Finance: New Legislation on Banking and Finance Business

³⁵⁷ Interview, Emma Stuart-Beck

³⁵⁸ Ibid.

³⁵⁹ Ibid.

received sufficient investor funds and extends the loan to the borrower of the relevant credit project.

This does however not qualify as deposit taking. The money received by the platform operator is merely pooled in one account and only held by the platform for the sole purpose of transferring it on to another person. This does not meet the requirements of deposit taking. Deposit taking rather requires designated deposit accounts for each investor.³⁶⁰ In order to deposit money for an agreed term at an agreed (fixed or variable) interest rate, each investor would have to open a deposit account at the partner bank, i.e. a virtual sub-account to an account held in the platform operator's name. Deposits under a fixed interest rate will be locked for a pre-determined time period, depending on the fixed interest rate chosen. Interest rates will be applied from the day the investor's deposit is received until the last day of the lock-up period. Transfers from the deposit account will only be able to be made to an investor's account at another credit institution. The platform operator should define a right under the deposit agreement to use the deposited money for granting of consumer loans.

(2) Grant loans

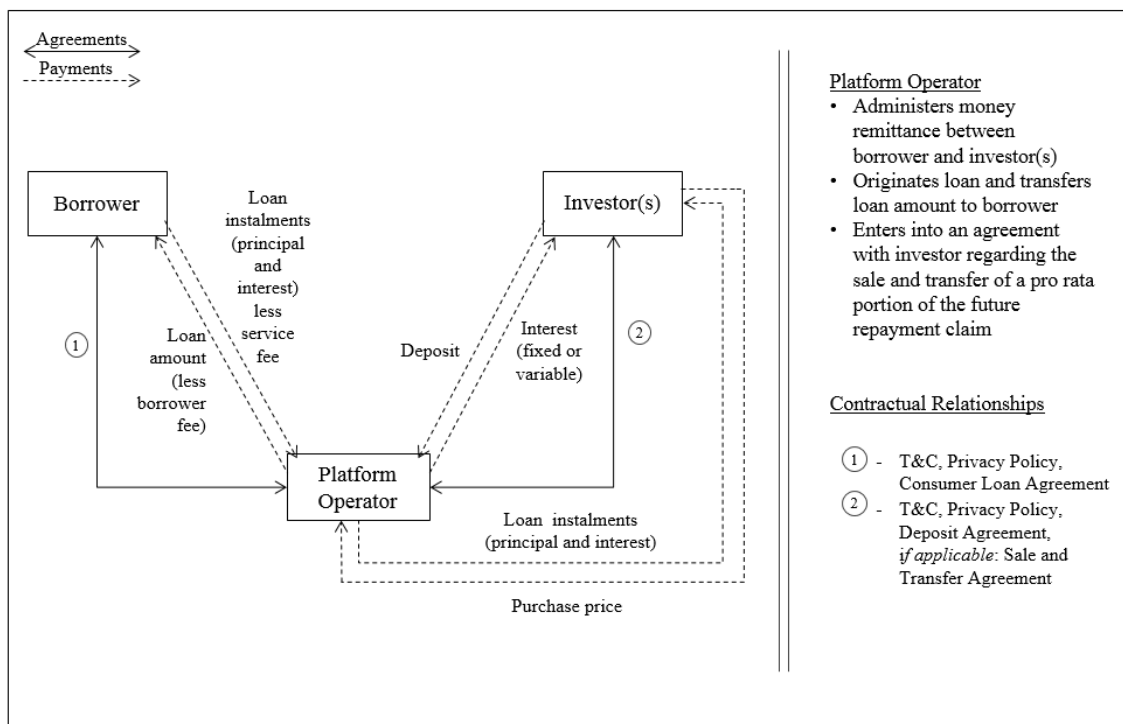
In addition to taking of deposits the platform operator would have to grant loans, i.e. offer a credit to the borrower and hence conduct direct peer-to-peer lending. Following the collection of sufficient funds, the platform operator would enter into a consumer loan agreement with the borrower once they accept the loan offer. The platform operator would then issue the loan to the borrower, net of the borrowers' service fee as agreed under the loan agreement, which the borrowers undertake to pay in addition to interest. The loan will be funded by the platform operator, either from deposits made by investors or by the platform operator's own equity.

The investors will be transferring money to the platform and this money will be repaid in accordance with the deposit agreement, thereby fulfilling the requirements of accepting repayable funds from the public, since the money will be made available to the depositor within one (1) year following termination. This money will be available to the platform operator during the term of the deposit, in the same way it would to a bank and can hence

³⁶⁰ Lendico research / discussion with lawyers

be used to finance loans. In addition the platform itself will be extending loans to the borrowers, thereby fulfilling the requirement of granting loans. Thus the platform conducts financing business in accordance with the BFB Act and as such is subject to a CMC license.

Below the process is represented in a simplified picture:



Simplified depiction of the model under the CMC license.

Figure 5³⁶¹

b) Indirect peer-to-peer lending

The platform operator could also conduct indirect peer-to-peer lending and thus being required permission under a payment institution license. In order to conduct indirect peer-to-peer lending the platform operator would be required to conduct payment services pursuant to ch. 1, sec. 2 PS Act, which includes, inter alia, money remittance services.³⁶²

Money remittance, according to ch. 1, sec. 4 of the PS Act is defined as payment service where funds are received from a payer without any payment accounts being created in

³⁶¹ Own figure based on the above description

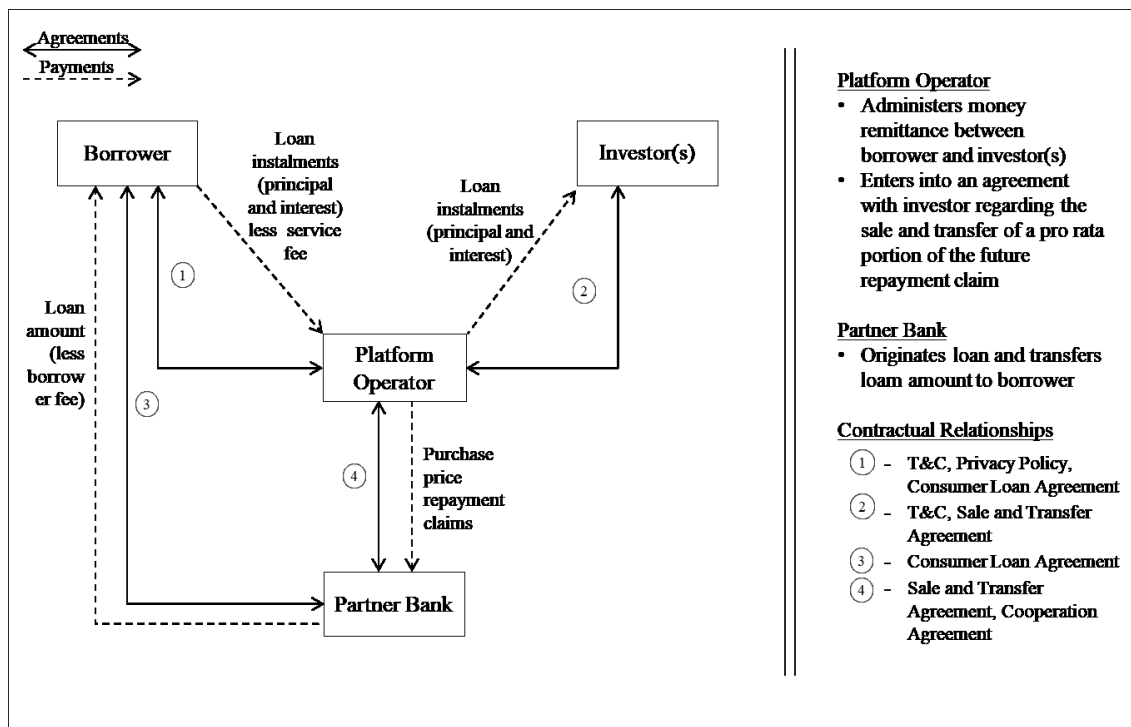
³⁶² PS Act, http://www.riksdagen.se/sv/Dokument-Lagar/Lagar/Svenskforfattningssamling/Lag-2010751-om-betaltjanste_sfs-2010-751/

the name of the payer or the payee either for the sole purpose of transferring a corresponding amount to a payee or to another payment service provider acting on behalf of the payee or where such funds are received on behalf of and made available to the payee.

The platform would thus have to receive funds from a payer on an account held by the company, i.e. no accounts would be allowed to be opened by the platform, for the sole purpose of transferring a corresponding amount or where the funds are received on behalf of and made available to the payee.

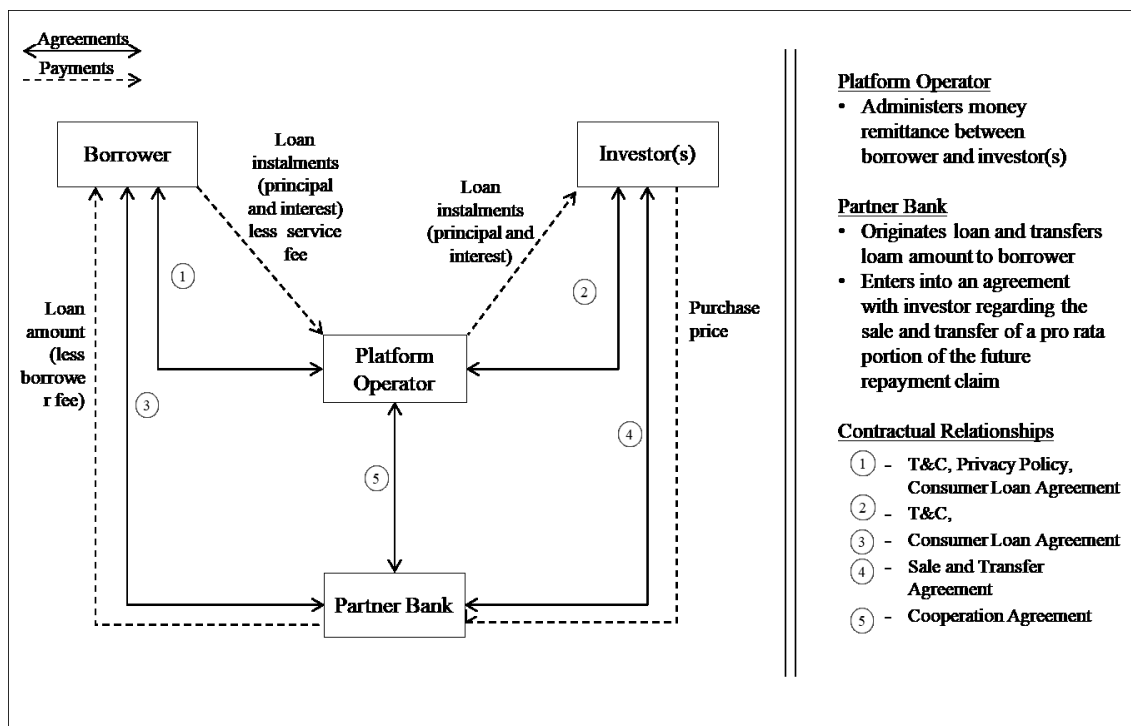
Borrowers would launch an application for a loan via the platform. The investors could then start to make commitments on a first come, first served basis. They would have to transfer the corresponding amount to the platform, which would have to receive all funds in one account. The bank would enter into a consumer loan agreement with the borrower and the extension of the loan would be subject to the condition precedent, that the platform has received the investors' monies. Once the financing of the loan would be ensured, the cooperating bank could either: (1) enter into a sale and transfer agreement of the future repayment claim with the platform who would in turn enter into a sale and transfer agreement with the respective investors corresponding to their *pro rata* share of the future repayment claim; or (2) directly enter into sale and transfer agreements with the investors regarding their *pro rata* share of the repayment claims, thereby circumventing the platform.

Below the process is represented in two pictures, one where the platform operator does participate in the sale and transfer of pro rata shares of the repayment claim (cf. *Figure 6a*) and one where the platform operator does not participate (cf. *Figure 6b*):



Sale and transfer agreement between partner bank and platform operator and the platform operator and investor(s) respectively.

Figure 6a³⁶³



Sale and transfer agreement directly between partner bank and investor(s), without involvement of the platform operator.

Figure 6b³⁶⁴

³⁶³ Own figure based on the above description

³⁶⁴ Own figure based on the above description

Concluding, if the platform operator did cooperate with a partner bank which would not grant the loan to the borrower, and did not accept deposits or repayable funds, but would only accept investors' commitments in relation to a loan for the sole purpose of transferring the money on, the platform operator would be subject to a payment institution license.

3. Summary

In Sweden it is possible for platform operators to conduct both direct and indirect peer-to-peer lending, without having to get licensed as a bank. Which business model is selected, depends on whether the platform operator chooses to act as a lender or whether it chooses to cooperate with a partner bank to act as the lender.

In order to conduct direct peer-to-peer lending and apply for a CMC license, the platform operator has to conduct either banking or financing business. The requirements for banking business can be difficult to fulfil for a platform operator as the definition of deposit is narrow. However, the requirements for financing business, the acceptance of repayable funds and the granting of loans, are fulfilled by direct peer-to-peer lending, which therefore requires a CMC license. Indirect peer-to-peer lending also requires permission from the SFSA. Although the granting of loans is not permitted under a payment services license, the conduct of payment services, i.e. the receipt and transfer of funds, is regulated and requires permission.

II. Consumer protection

The borrowers and investors shall be informed about the product the platform offers and certain risks that can arise when using the product in a clear and prominent way prior to the conclusion of the contract with the platform operator. The requirements in relation to such pre-contractual information are set out below.

1. Pre-contractual information for borrowers and investors

The platform shall inform the consumer about and share the following information through different means in a readable and digital format prior to the conclusion of an

agreement and which is accessible as soon as possible after the agreement has been concluded:

a) Information for borrowers

aa) Standard European Consumer Credit Information

Borrowers shall receive the Standard European Consumer Credit Information before entering into a loan agreement, including *inter alia* the type of credit involved; the names, registration numbers and addresses of the creditor (including its telephone number or e-mail address), the amount of the credit and the conditions governing the drawdown the duration of the credit agreement, the borrowing rate, the conditions governing the application of the borrowing rate, stating the index or reference rate, as well as periods, procedures, and other conditions for changing the borrowing rate, the annual percentage rate charge, illustrated by a representative example, and the total amount which is to be paid by the consumer, the size, number and due dates of repayments, fees deriving from the credit agreement and the conditions under which those fees may be changed, sanctions for late payment; the right of withdrawal (Sw. *ångerrätt*) and the right to make early payments.

bb) Terms and conditions

The terms and conditions shall contain an extensive description of the application process for borrowers, a step-by-step description from the loan creation to the secondary sale of the loan agreement, and the information and personal data requested from the borrower, as well as the use of such data and information (additionally, the data privacy policy shall describe all use of the information in a clear and transparent way).

In the terms and conditions, the borrowers shall be furthermore informed about the potential sale and transfer of their loan agreement to third party investors.

b) Information for investors

Investors should be informed of the investment risk attached to a secondary market place, the need of diversification and that payments from the borrowers as loans are unsecured. This shall be reinforced in the sale and transfer agreement and will be described in further detail below.

Investors shall furthermore be informed of the deposit conditions and the fact that the platform operator might use the funds in the deposit account to invest into loan projects.

Additionally investors shall be informed about the mandatory deposit insurance, i.e. their deposits will be secured up to EUR 100,000 by the Swedish deposit guarantee scheme.

c) Information for both borrowers and investors

aa) Representative example

By means of advertising included on the platform, users shall receive a representative example on how the interest rate is calculated depending on certain variables, in accordance with section 7 of the Consumer Credit Act (SFS 2010:1846). The representative example is calculated taking into account (i) the borrowing rate, fixed or variable or both, together with particulars of any charges included in the total cost of the credit to the consumer, (ii) the total amount of credit, (iii) the annual percentage rate of charge, (iv) if applicable, the duration of the credit agreement, (v) in the case of a credit in the form of deferred payment for a specific good or service, the cash price and the amount of any advance payment; and (vi) if applicable, the total amount payable by the consumer and the amount of the instalments.

bb) Other information

In the concluded contract, the consumer shall be informed about the manner in which disputes arising from the contract will be handled, which country's law shall govern the contract and which court has jurisdiction.

The consumers shall be informed about handling of complaints, the identity of the complaints manager as well as how the consumer shall submit a complaint against the platform operator through the privacy policy and on the company's website.

The consumers shall furthermore be informed regarding the guidance which may be obtained from the Swedish Consumers' Banking & Finance Bureau and the Swedish Consumers Insurance Bureau as well as through municipal consumers' advice officials. Additionally, since the platform operator's operations are subject to authorisation, the

consumers shall be informed of the relevant supervisory authority, the Swedish Supervisory Authority.

Besides, the consumers shall be informed that taxes, fees or costs which may result from the contract will be neither payable via the platform nor imposed by it, of the manner of payment and performance, that the applicable provisions concerning premature or unilateral termination of the contract and, that the consumers are informed of which country's marketing laws have been followed, prior to the conclusion of a contract

2. Information for investors regarding investment risks

Investors should receive general information regarding investment risks on the platform's website, when they register on the platform and in the terms and conditions, and should receive more detailed information when they place bids.³⁶⁵ Furthermore, they shall be able to inform themselves about the offered investment product on the website before they register and before they place bids.

a) General information regarding investment risks on the website

The website should contain a dedicated section for investors in relation to investments. Before they even register on the platform they will thus have the possibility to inform themselves about the investment product and any associated risks in a section that explains how the platform's product works.

The investors shall be especially informed about the following:

- What kind of product the company offers;
- Which kind of return they can expect in relation to the different risk classes;
- An explanation of the different risk classes;
- How and when they will receive payouts;
- That in case the borrower does not repay his/her installments, they might lose their investment;

³⁶⁵ Interview, Emma Stuart-Beck

- That it is advisable to diversify their portfolio in order to minimise the impact of possible credit losses and that diversification can be achieved in relation to the investment amount, the risk classes and the duration of the loan.

b) Frequently asked questions (FAQ) section

In addition to that relevant questions, like *inter alia*,

- “What is done by the company in relation to the safety of my investment?”,
- “How can I invest?”,
- “How can I control the risk level of my portfolio?”

shall be answered in the FAQ section. The list of questions shall be reviewed and improved regularly.

c) Terms and conditions

The terms and conditions, that have to be accepted by the investor, shall at a minimum contain the following detailed information regarding investment risks.

Investing through the platform results in certain (high) risks, including that borrowers may not be able to comply with their repayment obligations under the loan agreements and as a result thereof investors can lose their total invested amount or a part thereof.

Investments made through the platform do not fall under any kind of guarantee scheme. The platform will not provide advice to the Investors in relation to their intended investment(s). Investors should therefore make their own assessment of the suitability of an investment and should preferably contact their legal and tax advisors before investing.

In order to mitigate these risks it is advisable to spread the amount to be invested over several loans. Furthermore, investors should in particular take into account the following risks:

- the borrower has a statutory right to prepay the outstanding loan in whole or in part, at any time and an early repayment can consequently result in a partial or complete loss of the investor's return on investment;
- if the Borrower does not repay the loan, there may be a complete default, and thus ultimately a total loss of the Investor's investment;

- if a debt collection agency is instructed to collect the receivables under the loan agreement or sells and assigns the receivables under the loan agreement to a debt collection agency the investor may still lose the investment completely or only receive a small portion of his or her investment; and
- investments made by the investor do not fall under the scope of the Swedish deposit insurance guarantee (Sw. *insättningsgaranti*) or any other guarantee scheme (deposits are not considered investments for purposes of this section).

d) Information provided when placing bids

Furthermore the investors shall be informed again about investment risks before they bindingly place a bid. This will at minimum contain information regarding the possible loss of the investment in case the borrower defaults on his repayments.

Consequently investors can inform themselves before registration and once they are registered before placing bids. Additionally the investors shall be informed about investment risks in the terms and conditions upon registration and before bindingly placing a bid on the website.

D. Regulation of peer-to-peer platforms in the Netherlands

I. Regulation of consumer lending in relation to peer-to-peer lending

1. General principles

First it will be investigated how lending is regulated in the Netherlands and which kind of financial intermediaries are allowed to grant loans. Subsequently it will be explored which license requirements apply to peer-to-peer lending platforms.

De Nederlandsche Bank (“**DNB**”) and the Netherlands Authority for the Financial Markets (“**AFM**”) supervise financial institutions, such as banks and insurance companies, in the Netherlands in order to protect businesses and consumers who entrust

their money to these institutions.³⁶⁶ The AFM supervises the conduct of undertakings, while the DNB exercises prudential supervision.³⁶⁷

Crowdfunding platforms which enable borrowers to lend money and investors to participate in such loan projects through investments fall under the supervision of the AFM, since the AFM regards the activities of such platforms as mediation in nature and the products, lending and investing, as financial products.³⁶⁸

2. Legal analysis

The peer-to-peer platform engages in different activities, which include among others the origination of loans and the sale and transfer of repayment claims as well as the servicing of defaulted payments.

According to sec. 2:6 Act of 28 September 2006, on rules regarding the financial markets and their supervision (Act on Financial Supervision) (*Dutch: Wet van 28 september 2006, houdende regels met betrekking tot de financiële markten en het toezicht daarop (Wet op het financieel toezicht)*) (the “WFT Act”) no party may offer credit in the Netherlands without a license granted for that purpose by the AFM.

The AFM has a supervisory framework for each, the intermediation of loans and origination of loans, accordingly. Both include the provision of finance to consumers in the form of loans funded by private lenders, the difference being that under one framework the platform merely acts as intermediary, indirect peer-to-peer lending, while under the other, direct peer-to-peer lending, the platform itself acts as credit provider.³⁶⁹ These license requirements will be analysed below.

³⁶⁶ Government of the Netherlands: Supervision of the financial sector

³⁶⁷ AFM, <http://www.afm.nl/nl-nl/over-afm/werkzaamheden/verantwoordelijkheden>

³⁶⁸ AFM, Crowdfunding - Towards a sustainable sector and Interview, Joris van Horzen

³⁶⁹ AFM, Crowdfunding - Towards a sustainable sector, p. 4; Note: Since 2015 the AFM does not differentiate between intermediation and origination anymore. The AFM has rather taken the stance, that irrespective of the platform acting merely as intermediary or originator of the loan, the full license according to sec. 2:6 WFT is required (Interview, Joris van Horzen).

a) Basis for the analysis

The analysis, which license requirements apply, will be conducted with regards to the process sequence for transactions initiated via the platform operator and payment foundation as described below:

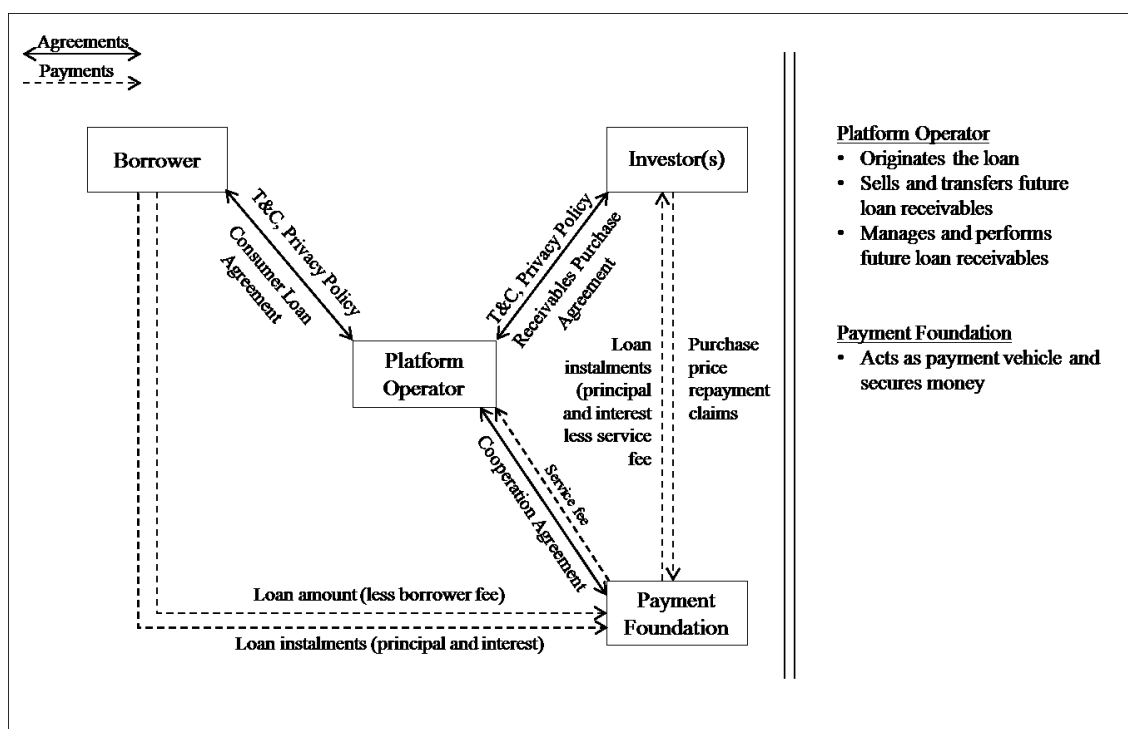


Figure 7³⁷⁰

The platform operator enters into a loan agreement with each borrower under the condition precedent, that the loan has been completely funded by investors. The loan will then be offered to investors for funding via the platform for a pre-defined period of time. Subsequently the platform will enter into an agreement with each participating investor regarding the sale and transfer of the receivables under the loan agreement on a pro rata basis, subject to the condition precedent that the loan agreement becomes effective. The investors will hence transfer the purchase price to the platform corresponding to their respective share. Once the platform has received all the funds in relation to a credit project, the loan agreement will become effective and the loan amount will be transferred to the borrower. Following the sale and transfer agreements with the investors will become effective.

³⁷⁰ Own figure based on the description

Payments from investors to borrowers and vice versa are handled by a separate entity, a payment foundation. According to sec. 1:102 WFT Act, the platform is required to cooperate with a payment foundation, in order to receive and transfers monies. The payment's foundation sole purpose is to hold and mediate investor monies, in order to protect investors in the case of the platform's insolvency. Due to the use of a payment institution as a separate entity, investor monies are separated from the platform's monies and as thus will not become part of the bankruptcy estate.³⁷¹

b) License requirements

In order to investigate the rules that apply to direct peer-to-peer lending it needs to be investigated whether the platform engages in the origination of loans and hence requires a license according to sec. 2:6 WFT.

aa) Credit institution

The platform operator is neither a bank nor an electronic money institute and hence does not qualify as credit institution.

bb) Financial institution

A financial institution is a party, not being a credit institution, that has as its main business the performance of one or more of the activities referred to under 2-12 of Annex I to the PSD, or the acquisition or holding of units. A credit institution is defined as a bank or electronic money institution.

The platform operator is neither a bank, nor an electronic money institution, nor does it participate in the acquisition of units. But it could perform one of the activities listed under 2-12 of Annex I to the PSD:

- (1) Services enabling cash to be placed on a payment account as well as all the operations required for operating a payment account;

³⁷¹ Interview, Joris van Horzen

- (2) Services enabling cash withdrawals from a payment account as well as all the operations required for operating a payment account;
- (3) Execution of payment transactions, including transfers of funds on a payment account with the user's payment service provider or with another payment service provider:
 - execution of direct debits, including one-off direct debits;
 - execution of payment transactions through a payment card or a similar device; and
 - execution of credit transfers, including standing orders;
- (4) Execution of payment transactions where the funds are covered by a credit line for a payment service user:
 - execution of direct debits, including one-off direct debits;
 - execution of payment transactions through a payment card or a similar device; and
 - execution of credit transfers, including standing orders;
- (5) Issuing and/or acquiring of payment instruments;
- (6) Money remittance; and
- (7) Execution of payment transactions where the consent of the payer to execute a payment transaction is given by means of any telecommunication, digital or IT device and the payment is made to the telecommunication, IT system or network operator, acting only as an intermediary between the payment service user and the supplier of the goods and services.

The platform operator could conduct one of the services listed as payment services. If the platform operator were to establish an own account system in order to receive and forward the borrowers' and investors' payments, the platform operator could operate a payment account ((1), (2)) or handle the execution of payments ((3), (4)). However the platform itself is not allowed to handle the payments, i.e. money flow through the company, in order to ensure segregation of assets.³⁷² Payments are handled by a separate entity, a payment foundation, according to sec. 1:102 WTF, in order to ensure that customers' assets are separated from the company's assets.³⁷³ Consequently even in case of the

³⁷² AFM, Newsletter Crowdfunding, sec. 3

³⁷³ Ibid.

platform's bankruptcy or in case the platform runs into payment problems the customers do not face the risk of losing their investment. Hence the platform does not conduct any of the activities listed in (1) – (4).

Neither will the platform operator issue or acquire payment instruments, nor conduct money remittance.

The platform operator therefore does not qualify as financial institution.

cc) Financial service provider

According to the WFT Act a financial service provider is defined as a party that offers a financial product other than a financial instrument that advises on a financial product other than a financial instrument or that provides brokerage services, provides reinsurance brokerage services or acts as an authorised agent or authorised sub-agent.

The platform operator does not advise on financial products other than financial instruments, nor provide brokerage services, reinsurance brokerage services, nor act as an authorised agent or sub-agent. Therefore it has to be analysed whether the platform operator offers a financial product other than a financial instrument.

Financial products, financial services and financial instruments are also defined in sec. 1:1 of the WFT Act as follows. Financial products include investment objects, current accounts including the ancillary payment facilities, electronic money, financial instruments, credits, savings accounts including the ancillary savings facilities and insurance contracts of another product to be specified by Decree.

Financial services include offerings, advice on financial products other than financial instruments, provision of brokerage services, provision of reinsurance brokerage services, acting as a clearing institution, acting as an authorised agent or authorised sub-agent, provision of investment services and provision of investment activities.

Financial instruments include securities, money market instruments, units in a collective investment scheme, not being securities, financial contracts to settle differences and

options, futures, swaps, forward rate agreements and any other derivate contracts relating to securities, commodities, etc.

In order for the platform operator to qualify as financial service provider, it first of all needs to be excluded that it offers financial instruments. Since the platform does not offer any of the financial instruments listed above it does not offer financial instruments and consequently can qualify as financial service provider if it offers a financial product.

Thus the platform could qualify as financial services provider by offering, i.e. granting credits. Credit is defined as monetary credit or commodities credit, whereby a monetary credit means to make a sum of money available to a consumer, regarding which the consumer is required to make one or more payments. The platform operator transfers the loan amount to the borrower, i.e. makes a sum of money available to a consumer. Subsequently the borrower has to repay the loan (including interest) in fixed monthly instalments, i.e. the borrower is required to make more than one payment in relation to the loan. Hence, the platform operator grants credits to consumers, borrowers.

The platform itself consequently provides finance in the form of granting of credits to consumer borrowers and assigns the right to these claims to consumer investors. The platform operator thus engages in origination of loans and qualifies as financial service provider that and requires a license according to sec. 2:6 WFT.

3. Summary

In the Netherlands the granting of credits is regulated and requires a license from the AFM. Supervisory frameworks exist for both the intermediation of loans and the granting of loans. Under direct peer-to-peer lending the platform operator grants the loan to the borrower and hence qualifies as financial service provider, requiring permission from the AFM.

II. Consumer protection

The respective consumer protection requirements will be laid out cursorily below, based on relevant information gained in an expert interview, as other than the requirements under German, English and Swedish law, the requirements under Dutch law are only available in Dutch.³⁷⁴

1. Pre-contractual information for borrowers

Borrowers shall receive the Standard European Consumer Credit Information before entering into a loan agreement, including *inter alia* the type of credit involved, the names, registration numbers and addresses of the creditor (including its telephone number or e-mail address), the amount of the credit and the conditions governing the drawdown the duration of the credit agreement, the borrowing rate, the conditions governing the application of the borrowing rate, stating the index or reference rate, as well as periods, procedures, and other conditions for changing the borrowing rate, the annual percentage rate charge, illustrated by a representative example, and the total amount which is to be paid by the consumer, the size, number and due dates of repayments, fees deriving from the credit agreement and the conditions under which those fees may be changed, sanctions for late payment, the right of withdrawal and the right to make early payments.

They shall also be informed, that their creditworthiness will be checked together with other conditions, like *inter alia* their residence, which should be in the Netherlands and fraud, and that the decision whether the borrower is granted the loan will only be made after these preconditions have been verified.

2. Information for investors

Investors shall be informed about the general risks of an investment. These risks should be described on the platform's website in a designated section as well as during the registration process.

³⁷⁴ The most relevant consumer protection requirements have been gathered in an interview and elaborated in this section.

They shall be informed that investing through the platform results in certain (high) risks associated with loans. These include the possibility that a borrower may not be able to comply with their obligations under the loan agreement, i.e. defaults, and consequently, the investor may lose his/her investment or a part thereof and may not receive interest on the amount invested.

Investors will be informed that in order to mitigate their risks they should spread their investment across several loans and that the investments do not fall under a guarantee scheme. Apart from that the platform shall not give individual advice to investors in relation to their intended investment(s). Rather investors will be informed that they should make their own assessment of the suitability of an investment and/or contact their legal and tax advisors before investing through the platform.

Part IV: Towards a standardised European regulation for financial intermediation by peer-to-peer lending operators in the consumer credit market

A. Prerequisites for the application of banking licenses

The following sections will list the main requirements, institutions have to fulfil in order to apply for a banking license in different jurisdictions. This will serve as a basis for a following discussion of how and why these requirements differ and will thus not be exhaustive and/or detailed, but will focus on the main requirements that need to be fulfilled by peer-to-peer lending platforms in Germany, the UK, Sweden and the Netherlands accordingly.

I. Application for banking business in Germany

Institutions may only conduct commercial banking business if they have received authorisation from Bafin according to sec. 32 (1) KWG. The obligation to apply for authorisation shall protect the functionality of the financial market as well as customers' assets and is hence intended to prevent businesses which do not have sufficient financial means and who are personally and professionally not suitable to conduct banking business.³⁷⁵ The design of sec. 32 KWG as a prohibition with reservation with regards to granting permission shall ensure that only such persons are allowed to conduct banking business or financial services who can guarantee a proper management as regards both personnel and financials.³⁷⁶

Bafin consequently may only grant the authorisation to conduct banking business according to sec. 32, 33 (1) KWG if, among others, the following minimum requirements are fulfilled.

An institution first of all has to demonstrate that it is endowed with a sufficient initial capital upon commencement of the business. The initial capital varies depending on the

³⁷⁵ Ehlers/Fehling/Pünder/Ohler, par. 32, Rn. 40

³⁷⁶ Ibid.

intended business. For an institution that intends to act as a deposit-taking credit institution the initial capital is at least 5 million Euro (sec. 33 (1d) KWG).

Two managing directors need to be appointed according to sec. 33 (1) no. 5 KWG, in order to ensure the four-eye-principle.³⁷⁷ The managing directors need to be professionally suitable and personally reliable (*zuverlässig*) (sec. 32 (1) no. 3, 4, sec. 33 (1) no. 2 KWG). In order to prove the professional suitability a comprehensive CV as well as a detailed description of the educational and theoretical knowledge and professional background are required.³⁷⁸ Additionally they need to show at least three years of experience in a managerial role. The personal reliability will be checked against the Federal Central Register (*Bundeszentralregister*) as well as the Central Trade and Industry Register (*Gewerbezentralregister*).³⁷⁹

The company also has to disclose any holders (entities as well as personal representatives) of significant holdings and the size of such holdings in the company that is filing for the application. Additionally the personal representatives of any legal person need to be disclosed. Bafin will investigate whether they meet the interests of sound and prudent management of the institution and whether the personal representatives are personally liable (sec. 32 (1) no. 3 KWG).

The application furthermore needs to contain a sound and viable business plan according to sec. 32 (1) no. 5 KWG, indicating the nature of the proposed business, the organisational structure as well as internal control systems and procedures. The business plan is intended to serve as a basis for a prognosis with regards to the business' future stability and soundness and a particular focus on precautionary measures with regards to risk management.³⁸⁰ The registered head office, i.e. a physical and real presence, must be located in Germany (sec. 33 (1) no. 6 KWG).

³⁷⁷ Ibid., Rn. 43

³⁷⁸ Boos/Fischer/Schulte-Mattler/Fischer, KWG, par. 32, Rn. 43; Bafin, Zulassung von Banken und Finanzdienstleistern sowie von Zahlungs- und E-Geldinstituten

³⁷⁹ Bafin, Zulassung von Banken und Finanzdienstleistern sowie von Zahlungs- und E-Geldinstituten

³⁸⁰ Ehlers/Fehling/Pünder/Ohler, par. 32, Rn. 44

II. Application for the business of operating an electronic system in relation to lending in the UK

Firms that want to conduct regulated activities need to apply for authorisation from the FCA. The activities of peer-to-peer platforms are regulated as the operation of an electronic system in relation to lending and hence require authorization.

The minimum threshold conditions are set forth in schedule 6 FSMA and explained and interpreted by the FCA in the FCA's Threshold Conditions ("COND") manual. The FCA threshold conditions represent the minimum requirements a firm is required to fulfil and continue to fulfil in order to be granted authorization (sec. 1.2.1 COND).

First, according to sec. 2.2.1A(1) COND, similarly to the requirements under German law, for bodies incorporated in the UK, the company's head office and registered office have to be located in the UK. Otherwise according to subsection (2) and (3), for other companies, whose head office is in the UK the company has to carry on business in the UK. The head office is where a company's central management, i.e. the directors and other senior management, and control, i.e. the central administrative functions, are located (sec. 2.2.3 COND).

Second, according to sec. 2.3 COND effective supervision needs to be possible. This means that the FCA must be capable of effectively supervising the company with regards to a variety of circumstances according to sec. 2.3.1A COND, which include inter alia, the nature of the regulated activities, the complexity of provided products, the organization of the business, whether the company is subject to consolidated supervision and whether the company has close links with another company, i.e. a parent undertaking or subsidiary.

Third, according to sec. 2.4 COND, the company has to have appropriate resources in relation to the regulated activity conducted. This is determined based on the nature and scale of the business, the risks to the continuity of the service and any membership of a group and the effect this may have (sec. 2.4.1A(2) COND). Furthermore the appropriateness of the financial resources is determined with regards to the provisions made by the company and the means by which risk incidents are managed (sec. 2.4.1A(3))

COND). The appropriateness of non-financial resources moreover is also assessed based on the skill and experience of the company's management (subsection (4)).

Additionally the company needs to be suitable, i.e. fit and proper (sec. 2.5.1A(1) COND), with regards to the conducted activity. The company needs to ensure that its activities are conducted in an appropriate manner, especially with regards to the interests of the consumers and the integrity of the financial system, that its managers, as required under German law, have adequate skills and experience, that its business is conducted in a sound and prudent manner and that the exposure to financial crime is minimised to the extent possible to carry on the business as well as that the company complies, or is ready to comply, with any requirements imposed, or to be imposed, by the FCA.

Finally the company's business model has to be suitable for the conduct of the regulated activity that the company wishes to carry on, according to sec. 2.7.1 COND. This is determined based on whether the business model is compatible with the company's affairs being conducted in a sound and prudent manner, whether the company satisfies the interests of consumers and the integrity of the UK's financial system.

Besides, the FCA encourages companies to take the following steps in addition to the threshold conditions.³⁸¹ These include, the submission of a business plan detailing the planned activities as well as related risks, budget and resources, having a suitable website, that is either already live or at a suitably advanced stage (e.g. using a test site or screenshots, in order to being able to demonstrate how it will operate, the user interface and the functionalities available to a user) should the company be authorized. Finally the company should understand the FCA's requirements for authorisation and the permission profile which applies and submit a complete application, including an outline of the regulated activities the company intends to conduct.³⁸²

The FCA has also introduced prudential requirements with regards to regulatory capital in 2014, which in contrast to requirements for initial capital under German law, are significantly lower. Transitional rules will apply until March 2017, which require the

³⁸¹ FCA, Review of the regulatory regime for crowdfunding, p. 6

³⁸² Ibid.

higher of a fixed minimum amount of 20,000 pounds or (0.3% of the first 50 million pounds lent by investors) + (0.2% of the next 450 million pounds lent by investors) + (0.1% of all the money lent above 500 million pounds).³⁸³ From April 1st, 2017 the financial requirement will be the higher of a fixed amount of 50,000 pounds or (0.2% of the first 50 million pounds of total value of funds outstanding) + (0.15% of the next 200 million pounds of total value of funds outstanding) + (0.1% of the next 250 million pounds of total value of funds outstanding) + (0.05% of any remaining balance of total value of funds outstanding above 500 million pounds).³⁸⁴

III. Application for banking and/or financial business in Sweden

Institutions offering banking and/or financial services are required to apply for a license from the SFSA. Before granting the license, the SFSA will, inter alia, review the company's initial capital situation, business plan, ownership and corporate management.

The SFSA will only grant the authorisation for a credit market company license if the following minimum requirements are fulfilled.

A credit market company must, upon commencement of the business and the time of the decision regarding the license, demonstrate that it has an initial capital of EUR 5 Million (ch. 11, ch. 3 sec. 7 BFB Act). However, if the total assets of the planned business can be estimated to amount to not more than SEK 100 Million or where the company's account are maintained in Euro, EUR 12 Million, a lower initial capital may be granted to a credit market company with a minimum of EUR 1 Million (ch. 11, ch.3 sec. 7 BFB Act).

The board of directors of a credit market company must consist of a minimum of three board members. The majority of these board members have to be external board members, i.e. not employed by the company. The board of directors must appoint a chairman of the board as well as a managing director, who cannot be the same (ch. 11 ch. 10, sec. 7).

³⁸³ FCA, PS14/4, p. 18

³⁸⁴ Ibid., p. 20

The suitability of the board of directors as well as the managing director will be assessed by the SFSA, with regards to inter alia, their insight and experience in order to participate in the management of a credit institution (ch. 3, sec. 2, no. 4), based on information collected from, inter alia, the police and the Swedish Tax Agency, or where any of the persons is a foreign citizen, from the corresponding national authority.

The company also has to disclose any holders (entities as well as personal representatives) of significant holdings and the size of such holdings in the company that is filing for the application. Additionally a direct or indirect ownership of shares or a participating interest, which gives the owner a qualifying holding need to be disclosed. The owners will be ownership assessed by the SFSA in order to ensure sound and prudent management of the institution as well as the personally liable representatives.

The company shall submit a business plan with a detailed description of the intended operations, the company's organization, internal rules on risk management, anti-money laundering and how it intends to fulfil sound business practices (sec. 8 ff. FFFS 2014:8). The registered head office, i.e. a physical and real presence, must be located in Sweden. Additionally the company has to implement a policy framework outlining how, inter alia, risk management, internal and external audit, anti-money laundering, consumer protection will be performed and safeguarded.

IV. Application for banking and/or financing business in the Netherlands

No person or business may offer credit in the Netherlands without having obtained a license from the AFM for that purpose, according to sec. 2:6 WFT Act. The AFM will only grant the license if the following license requirements are fulfilled.

A consumer credit provider must upon the commencement of its business have a minimum amount of equity capital available (sec. 2:6, 3:53 (1) WFT Act). However if the company can show that it cannot reasonably comply with the minimum equity capital requirements, an exception will be granted if the company can prove that the objectives which the minimum equity capital seeks to achieve will be achieved in other ways.

The company shall have its registered office in the Netherlands and a minimum of two managing directors (sec. 2:6, 3:15 (1), (2) WFT Act). The managing directors need to be suitable and have sufficient experience in order to carry out the day-to-day operations (sec. 2:6, 3:8, 3:9 WFT Act). The experience and expertise of the respective person is checked based on the education, professional expertise and references. The suitability is determined based on references as well as external information available to the AFM or other supervisors in the financial sector and checked against police records. Furthermore the managing directors will be tested on their integrity.

The company shall furthermore ensure the expertise of its employees as well as other individuals directly involved in the provision of intermediary services. This shall be ensured by only employing managers who have sufficient expertise in the financial sector in order to safeguard the quality of the financial services opposite the consumer or client.

The company must implement a culture of controlled and fair business operations by implementing a policy framework (sec. 2:6, 3:10 (1), (2), 3:17 (1), (2) WFT Act) with regards to the control of business processes and business risks, the integrity of the financial enterprise as well as the soundness of the financial enterprise.

B. Harmonisation of the regulatory environment for peer-to-peer lending companies

Following the analysis of the regulatory environment and the prerequisites for the application of banking licenses in Germany, Sweden and the Netherlands as well as an analysis of the rationale for the regulation of the banking business and license requirements in general, the question arises, whether the regulatory environment for peer-to-peer lending companies could be harmonised in Europe.

I. Obstacles under the current regulatory framework

First it should be investigated what kind of obstacles peer-to-peer lending platforms face under the current regulatory framework. Regulatory requirements can be difficult to overcome for young companies and additionally they face difficulties that strike at the heart of their business models.

Peer-to-peer platforms, can hardly compete with traditional banks on the basis of lower rates for borrowers or higher returns for investors. They, Fintechs (financial technology companies) in general, try to beat these traditional businesses with one major advantage: usability. Peer-to-peer lending platforms rely on the possibility to offer fast and easy registration processes that work for a majority of customers and which can be completed online. Additionally funding and pay-out of loans has to be conducted fast without any further actions needed to be taken. Peer-to-peer businesses, and Fintechs in general, do however experience difficulties with the implementation of such easy processes and unique selling positions (USP). Depending on the jurisdiction, the online registration process often has to be interrupted due to legal requirements for document-based verification of the customer or reference transactions (*Referenzüberweisung*) that need to be conducted³⁸⁵.

In Germany, for example, customers until recently had to identify themselves offline through an identification method performed by Deutsche Post (Postident), which required customers to personally show their ID at a post branch or identify themselves opposite a postman from Deutsche Post.³⁸⁶ Nowadays Deutsche Post and other identification service providers have introduced online identification processes where the person whose identity needs to be confirmed has to show his/her identity card to a customer service agent via a video chat.³⁸⁷ These online identification processes have however come under recent scrutiny by Bafin, which has introduced new rules for video identification methods in 2016.³⁸⁸ One of the biggest hurdles being, that only companies that fall within the definition of sec. 1 (1) KWG, i.e. credit institutions, will be allowed to use video ident,³⁸⁹ which does not apply to the majority of fintech companies.

Additionally Bafin requires reference transactions to be conducted, i.e. a small amount needs to be transferred to the new account by customers who want to open a bank account

³⁸⁵ Bafin, Rundschreiben 04/2016 (GW) – Videoidentifizierungsverfahren, sec. II. (5)

³⁸⁶ Simplified description of the offline identification process performed of Deutsche Post performed by post branches in accordance with the German Money Laundering Act (*Geldwäschegesetz*), cf.: <https://www.deutschepost.de/de/p/postident/identifizierungsverfahren.html>

³⁸⁷ Simplified description of the online identification process of Deutsche Post, cf.: <https://www.deutschepost.de/de/p/postident/identifizierungsverfahren.html>

³⁸⁸ Bafin, Rundschreiben 04/2016 (GW) – Videoidentifizierungsverfahren

³⁸⁹ Bafin, Rundschreiben 04/2016 (GW) – Videoidentifizierungsverfahren, preface

online. This poses a real threat, since it not only makes the registration process more difficult and time consuming, but it could become a conversion-killer, i.e. more customers could drop out of the registration process at this point. It is especially difficult for the main target group, younger customers, who may not be able to use a variety of fintech offers anymore, as they may not have another bank account yet³⁹⁰. Similarly people who come to Germany from outside the European Union and do not have a bank account in Europe will face problems under this requirement.³⁹¹

Furthermore peer-to-peer platforms also face regulatory obstacles that are difficult to overcome for young companies. In order to conduct direct peer-to-peer lending in Germany, peer-to-peer platforms would have to apply for a banking license themselves. However newly founded companies often struggle to comply with the extensive application requirements. A huge roadblock is the fulfilment of capital requirements, which can only be fulfilled if enough funding can be secured in order to hold sufficient equity capital in reserves against possible risks.³⁹² Moreover it can be very difficult for newly founded companies to fulfil the compliance requirements.³⁹³ A newly founded company first of all has to build a strong team and define all processes for its business operations. Indeed, processes can be defined and set up according to regulatory requirements and recorded in policies at the same time, however this is not only very time consuming, but it is extremely difficult to set up a compliance framework for a non-operative company on paper without the processes having been conducted before. A very experienced team is required, who in the best case, has conducted these processes before and knows how to define them. But it should not be forgotten that someone who knows how to perform the required actions may not be fit for defining them. Consequently the only possibility for a peer-to-peer company or any other Fintech to start its operations fast, at least in Germany, is to find a partner bank with a banking license to perform the regulated activities. This will be investigated in more detail below.

³⁹⁰ Schlenk, Bafin und Politik werfen Fintechs Steine in den Weg

³⁹¹ Ibid.

³⁹² Germany: initial capital requirement of 5 million Euro, United Kingdom: initial capital requirement of 20.000-50.000 pounds, Sweden: minimum capital of 1 million Euro

³⁹³ Own experience with the application of a license.

II. Different approaches towards the regulation of peer-to-peer lending

Germany and Sweden take a similar approach towards the regulation of and license requirements for banks and financial institutions and hence peer-to-peer lending platforms.³⁹⁴ However Sweden makes it easier for smaller companies to also operate peer-to-peer lending platforms due to exceptions to the application requirements and thus allows an easier entry into the market compared to Germany. The Netherlands take a radically different approach and allow any provider with a “light” license, which compared to a banking license is easier to obtain, to conduct peer-to-peer intermediation services, trying to lay out special requirements on the go. In the UK special rules for peer-to-peer lending platforms have been introduced based on consultations of the industry, which will be reviewed continuously and a complete post-implementation review that will be conducted after a period of two years.

In Germany only banks with a license from Bafin are allowed to conduct banking business, i.e. accept deposits and grant credits. This special statutory permission according to sec. 32 KWG is supposed to reflect the particular role of credit institutions in the financing of the economy as a whole and hence the exceptional sensitivity of trust that is inherent in the credit business.³⁹⁵ As described above in more detail, it is intended to protect the stability and functioning of the economy as well as investors. However it is questionable whether peer-to-peer consumer lending, which essentially focuses on the issuance of credits with relatively low amounts should fall within the same regulations as commercial banking business.³⁹⁶ The regulation of sec. 32 (1) 1 alt. 1 KWG could be interpreted restrictively with regards to its purpose.³⁹⁷ One approach could be to transfer the minimum amount limit (*Bagatellgrenze*) from the second alternative of sec. 32 KWG onto the first alternative.³⁹⁸ Another approach could be to transfer the reasoning of sec. 14 BGB and to exempt such activities of credit business from the regulation which are only intended for private investment purposes.³⁹⁹

³⁹⁴ Cf. investigation of the regulatory environment in each country (Germany, UK, Sweden, Netherlands) above under Part III.

³⁹⁵ Renner, *Banking Without Banks*, p. 266 and Fn. 66

³⁹⁶ Cf. Renner, *Banking Without Banks*, p. 266

³⁹⁷ Cf. Renner, *Banking Without Banks*, p. 266

³⁹⁸ Cf. Renner, *Banking Without Banks*, p. 266 and Fn. 68

³⁹⁹ Cf. Renner, *Banking Without Banks*, p. 266 and Fn. 69

Bafin however takes a different approach. As Bafin's president Felix Hufeld said during Bafin-Tech⁴⁰⁰ the same rules apply for "cool Startups" as for "successful businesses".⁴⁰¹ He further reinforced his position on equal regulatory treatments "same business, same risk, same supervision".⁴⁰² He nevertheless also said that Bafin did not want to intervene in the development of the market. He argued that regulation needs to adapt, but businesses also need the possibility to develop and grow.⁴⁰³ Furthermore promising business models are also welcome, even below the supervisory threshold.⁴⁰⁴ During the conference he even seemed open to the suggestion that Fintech business models shall only fall under Bafin's supervision once they have reached a critical size.⁴⁰⁵ Nevertheless, whoever fails to comply with supervisory rules will be shut down.⁴⁰⁶ Regulation will therefore evolve together with the Fintechs, businesses will fail and politics will react to that without ruining the market, Hufeld argues.⁴⁰⁷

Contrastingly the UK has introduced special rules and requirements for peer-to-peer lending already in 2014. Before the introduction of the regulation of peer-to-peer lending, the FCA undertook supervisory visits to understand the risks posed to the current statutory objectives as well as to assess the governance, management and controls of five market participants.⁴⁰⁸ End of 2013 the FCA also published a consultation paper detailing the proposed regulatory approach in relation to crowdfunding, i.e. loan-based crowdfunding, also called peer-to-peer lending, and investment-based crowdfunding. Feedback was collected and reviewed by the FCA, which led to some rules being changed due to the collected feedback.⁴⁰⁹ The rules in relation to peer-to-peer lending came into force on April 1st, 2014, subject to certain transitional rules, and were reviewed at the end of 2014 with a full post-implementation review planned at the end of 2016.⁴¹⁰ Additionally the requirements for initial capital are, similar to the approach taken in Sweden, significantly lower than in Germany.

⁴⁰⁰ Bafin's first Fintech conference took place on 28.06.2016

⁴⁰¹ Bafin-Tech 2016; Schlenk, Wer frisst wen?

⁴⁰² Bafin-Tech 2016

⁴⁰³ Ibid.

⁴⁰⁴ Ibid.

⁴⁰⁵ Cf. Schlenk, Wer frisst wen?

⁴⁰⁶ Ibid.

⁴⁰⁷ Bafin-Tech 2016

⁴⁰⁸ FCA, Review of the regulatory regime for crowdfunding, p. 7

⁴⁰⁹ FCA, PS14/4, p. 5

⁴¹⁰ Ibid., p. 7

However, although the UK has taken an innovative approach in introducing special rules and requirements for peer-to-peer lending, the rules that apply to peer-to-peer lending were implemented as amendments to the current regulations as set out in the FCA Handbook. It is thus difficult for new businesses to get a clear view of all the regulations that apply and that need to be fulfilled and followed. In order to make this more transparent, the regime for peer-to-peer lending should thus be simplified. The FCA could introduce a single comprehensive rulebook for crowdfunding, differentiating between loan-based and investment based crowdfunding.⁴¹¹

This approach has similarities with the approach taken by the Dutch AFM already in 2014.⁴¹² The AFM argued that the crowdfunding sector needs to be “given the opportunity to grow in a sustainable and responsible manner”.⁴¹³ This does however not mean that operators are not regulated at all, but the AFM applies a minimum level of requirements and otherwise uses the cooperation with such businesses to learn what kind of supervision and license requirements are needed “as the current legislation and regulation does not set adequate requirements”.⁴¹⁴ So sustainable growth in that context means the fulfilment of certain preconditions in order to combat risks associated with these businesses such as fraud or unsuitable funding and the dysfunction of platforms. The preconditions that shall be met include professionalism of the platforms, a minimum level of transparency, a certain degree of protection for lenders and borrowers and the cooperation also between platforms.⁴¹⁵ This is intended to ensure that legislation and regulation can grow with the development of the market in order to create appropriate legislation, whilst still ensuring a minimum level of supervision and protection. In 2014 the AFM distinguished three phases of market growth: the start-up market phase, the growth market phase and the mature market phase and indicated how the statutory framework should be applied and adjusted.⁴¹⁶ In the short and medium to long term the present regulatory framework shall be used while at the same time reviewing this

⁴¹¹ Cf. FCA, FS16/13, p. 25

⁴¹² AFM, Crowdfunding - Towards a sustainable sector, p. 3

⁴¹³ AFM, Crowdfunding - Towards a sustainable sector, p. 3

⁴¹⁴ AFM, Crowdfunding - Towards a sustainable sector, p. 3

⁴¹⁵ AFM, Crowdfunding - Towards a sustainable sector, p. 3

⁴¹⁶ AFM, Crowdfunding - Towards a sustainable sector, p. 4

framework with regards to market needs. In the long term it recommended that a new statutory framework be created with two regimes distinguishing loan- and equity-based crowdfunding, thus being able to take into account the specific requirements of each, ensuring prudential rules and specific regulations apply for the operation of such platforms.

Sweden was taking a similar approach, but has become much stricter with its regulation of peer-to-peer lending platforms since a scandal with a Swedish peer-to-peer lending platform occurred.⁴¹⁷ For pending and newly filed applications the SFSA is since then taking its time to review them thoroughly and investigate whether investor protection can truly be accomplished. However, in contrast to Germany, newly founded companies, like peer-to-peer lending platforms still have the opportunity to apply for a license that does not pose as extensive requirements as a full banking license, a credit market company license. Credit market companies can be described as small banks, i.e. they are also allowed to conduct banking and financial business and hence operate a peer-to-peer lending platform, however may not carry out as many activities as proper banks. Smaller companies can furthermore file for a lower initial capital, thus decreasing the financial obstacle of starting a banking or financial business and credit market companies have less reporting requirements than traditional banks, thus making the entry into the market and the operation of a direct peer-to-peer lending platform easier compared to Germany.

III. Is harmonisation possible?

1. Boundaries of national regulations

The supervisory restrictions for peer-to-peer lending in Germany are disadvantageous as they do not take into account its characteristics, but they rather question the economic advantages of peer-to-peer lending in general. One of the major benefits, the reduction of transaction costs, is evaded if peer-to-peer platforms have to enter into contracts with a banking partner regarding the issuance of consumer credits against consideration and the bank's intent to realise a profit.

⁴¹⁷ The management uncovered serious misconduct, including misuse of client money and lender money remaining trapped on the platform, cf. Evans, P2P lender TrustBuddy halts operations over 'misconduct'

In order to understand the purpose of the current regulations, it is important to recognise its underlying rationale and examine who shall be protected from what and whether the same protection is necessary for peer-to-peer lending?

The underlying purpose and the risks that shall be protected by sec. 32 KWG have already been described above, but shall be summarised here briefly. Banking regulation is supposed to act as a protection against possible threats and risks, i.e. to prevent damages to the banking system and investors from monetary losses.⁴¹⁸ Banking and especially credit institutions do not only have a decisive significance in the intermediation of capital to the economy, but disruptions can easily spread to and have an effect on other parts of the economy.⁴¹⁹ This can happen due to the financial functions performed by credit institutions. Credit institutions act as collector and distributor of money. Hence liquidity shortages and, even worse, the need to call back credits early would have grave effects on all demanders of money, and therefore the economy as a whole. Likewise, since credit institutions rely on external providers of funds, a much larger group of creditors would be affected compared to other businesses. Moreover difficulties of one credit institution most of the time also have effects on other credit institutions due to their connections and a loss of trust in the credit business as a whole. This shows that a failure of the banking business affects a much larger part of the economy as a whole than any other business.

Consequently par. 32 KWG has two main aims: firstly, to ensure a functioning banking business in the interest of the public and secondly, the protection of individual creditors and borrowers from risky business transactions.⁴²⁰ Thus the question arises, whether peer-to-peer businesses perform the same financial functions to the same extent as traditional banks, which would justify the application of the exact same rules and regulations.

As has been described above, the functions performed by traditional intermediaries, banks, and peer-to-peer platforms differ in how and to what extent they are carried out. Banks centralise the administration of capital and subsequently simultaneously carry out deposit and loan business and hence have to perform intermediary functions such as,

⁴¹⁸ Cf. Boos/Fischer/Schulte-Mattler/Fischer, KWG, par. 32, Rn. 120

⁴¹⁹ Cf. Ibid., Rn. 121

⁴²⁰ Cf. Renner, "Banking Without Banks"?, p. 270

payment functions, lot size, maturity and risk transformation as well as information transformation, which are prone to a lot of risks for the institution itself⁴²¹. Peer-to-peer platforms on the other hand create a state of business that does not require all of these financial functions to be performed, which therefore reduces the risks associated with this business. Peer-to-peer platforms do not centralise the administration of capital, but they pool all information and standardise transactions, enabling market participants, i.e. borrowers and investors, to make informed decisions and efficient transactions.⁴²² However they avoid the risks associated with lot-size, maturity and risk transformation. Investors choose their investments according to maturity and risk class and hence carry out these transformation functions themselves, the peer-to-peer operators merely create the platform to facilitate these actions by investors. Additionally the peer-to-peer platform does not invest third-party funds, but investors risk their own money.

Consequently the statutory permission that justifies the regulation of sec. 32 KWG for banking business cannot be applied to peer-to-peer business, since it poses different risks.⁴²³

2. Reform possibilities

The legislator should therefore rethink the application of sec. 32 KWG on peer-to-peer lending in consumer credits. Rather than applying a regulatory framework that cannot address the risks inherent in the business, the particular risks of peer-to-peer lending should be identified and a suitable regulatory framework created.

The British Financial Conduct Authority (FCA) has conducted a detailed market failure analysis in 2013, prior to the implementation of crowdfunding rules, which identified the key risks associated with peer-to-peer lending: mispricing of credit and investment risks, default of the platform provider and fraud, as well as the underlying market failures: information asymmetries, behavioural bias and illiquidity in the secondary market.⁴²⁴

⁴²¹ Cf. Ibid., p. 271

⁴²² Cf. Ibid.

⁴²³ Cf. Ibid., p. 272

⁴²⁴ FCA, CP13/13, p. 39 ff.

The risk of mispricing which results from lack of information and especially irrational behaviour, such as anchoring, relying only on one fact while not taking costs into account, herding of investors and from biases shall be combatted with reinforced disclosure requirements of the platform.⁴²⁵ Specific rules are not formulated, but the requirement that advertisements and information in relation to loans need to be “fair, clear and not misleading”.⁴²⁶ Secondly, the risk of default of the platform needs to be prevented by prudential requirements in order to protect investors. Measures taken are capital requirements as well as so called client money rules in order to protect client’s assets, when the platform is responsible for them (e.g. from insolvency).⁴²⁷ Compared to credit institutions the capital requirements for peer-to-peer platforms are relatively low (0.05% - 0.2% of the total value of loans outstanding).⁴²⁸ Additionally the operators have to notify the FCA if their total value of loans outstanding increases by at least 25%⁴²⁹ and have to appoint a collection agency to administer the loans in the event of failure of the platform⁴³⁰. Additionally, in order to combat fraud, the platform operator has to implement mechanisms that reduce the opportunity for fraud.⁴³¹

In 2015 it conducted a review of the market and undertook supervisory visits to assess the governance, management and controls to understand the risks posed by market participants.⁴³² It found, that companies provided a good understanding of credit risk, had robust anti-money laundering and know-your-customer checks in place and that clear information was made available to consumers interested in lending, hence enabling them to assess the risks and understand whom their money will be lent to.⁴³³ The FCA placed a large emphasis on ensuring that platforms are disclosing all information that is relevant to investors, so they can make an informed decisions.⁴³⁴ Furthermore they proposed to try to ensure, that negative comments about platforms are not deleted from forum sites in

⁴²⁵ Ibid. and FCA, PS14/14, p. 30 ff. and cf. Renner, “Banking Without Banks”?, p. 272

⁴²⁶ FCA, PS14/14, p. 9, 30

⁴²⁷ FCA, PS14/14, p. 18, 22

⁴²⁸ Ibid., p. 20

⁴²⁹ Ibid.

⁴³⁰ Ibid., p. 27 ff.

⁴³¹ FCA, CP13/13, p. 46

⁴³² FCA, Review of the regulatory regime for crowdfunding, p. 7

⁴³³ Ibid.

⁴³⁴ Ibid.

order to ensure that relevant risks are not overlooked, by both investors and the FCA itself.⁴³⁵

A market analysis like the one conducted by the FCA, as well as the continuing reviews, and the regulatory approach, that includes capital and reporting requirements, as applied in banking regulation, but also takes into account the characteristics of peer-to-peer lending could also be applied in Germany. This would lead to the creation of regulations that do not undermine the advantages peer-to-peer platforms try to create in usability and at the same time take into account the real risks of peer-to-peer lending. Consequently it would create the possibility for direct peer-to-peer lending enabling investors and borrowers alike to really profit from the financial functions performed by peer-to-peer platforms, including cost reductions.⁴³⁶

Peer-to-peer platforms could be required to fulfil certain minimum capital⁴³⁷ and reporting requirements, as implemented under the KWG, but taking into account the nature of peer-to-peer lending. Links could be drawn to the Swedish approach which differentiates between banking and finance business and the possibility to apply for a lower initial capital, whilst still applying capital standards. Additionally special information requirements towards investors⁴³⁸ could be implemented. The Small Investor Protection Act (*Kleinanlegerschutzgesetz*) which led to changes in the Capital Investment Act (*Vermögensanlagengesetz*) was supposed to eliminate regulatory loopholes in the protection of investors.⁴³⁹ However the application on peer-to-peer lending remains unclear and it would nonetheless be advantageous to draft information requirements tailored to the special risks associated with peer-to-peer lending.⁴⁴⁰ In order to ensure standardized business practices, standardized contracts could be drafted and required for the operation of peer-to-peer lending business.⁴⁴¹

The financial market would consequently open itself to new business models in relation to direct peer-to-peer lending while at the same time increasing the level of protection of

⁴³⁵ Ibid.

⁴³⁶ Cf. Renner, “Banking Without Banks”?, p. 272

⁴³⁷ Ibid.

⁴³⁸ Cf. Vermögensanlagengesetz

⁴³⁹ Weitnauer, Handbuch Venture Capital, Teil E, Rn. 86

⁴⁴⁰ Cf. information requirements in Sweden and the Netherlands

⁴⁴¹ Cf. Renner, “Banking Without Banks”?, p. 272

borrowers and investors due to specific and suitable rules, hence strengthening the banking business.⁴⁴² Furthermore the ongoing review of the market characteristics and rules in relation thereto ensures that such rules always address the risks posed in an effective manner and action against changing circumstances can be taken directly. As the FCA noted after its review, it contacted all of the reviewed platforms and informed them to make the necessary changes immediately. All of them were keen to comply and most of them made the changes immediately.⁴⁴³ This furthermore underlines the willingness and openness of the platforms to support the FCA and comply with existing rules.

⁴⁴² Ibid., p. 273

⁴⁴³ ⁴⁴³ FCA, Review of the regulatory regime for crowdfunding, p. 9

Conclusion and closing remarks

Peer-to-peer platforms face a regulatory landscape that is not adapted to their business models. Not only do most national regulators not address the particular risks posed by peer-to-peer lending, but make them subject to banking and financing rules that have existed for decades and hence cannot address their particular risks and take into account the special characteristics inherent in their business models. Additionally national regulators across Europe classify peer-to-peer lending differently without uniform standards.

Consequently, at least to date, one cannot say that a “banking without banks” does exist in Germany, since Bafin requires the participation of a traditional credit institutions in the process.

It is time to acknowledge peer-to-peer lending as a new financial service and introduce suitable regulations, preferably across Europe, taking other harmonization efforts as an example. Peer-to-peer lending has shown that it can replace traditional intermediaries, since it can perform the same financial functions performed by traditional intermediaries, directly and indirectly, posing less risks to the economy as a whole.⁴⁴⁴

⁴⁴⁴ Cf. Renner, “Banking Without Banks”?, p. 273

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Attachments

A. Interview with Emma Stuart-Beck, Partner in the Financial Service Practice Group at the law firm Vinge

The initial contact was established over the phone while the “interview” was conducted in writing during July and August 2015. I sent a list of questions to Ms. Stuart-Beck and she replied in writing. Please find the questions and answers below. The questions posed by Annalena Dierks are depicted in italics while the answers by Emma Stuart-Beck are depicted in normal writing.

Annalena Dierks:

Hi Emma,

thank you very much for taking the time to answer some questions in relation to my dissertation. As discussed, please find my questions below. They mainly relate to definitions of legal terms which I need in order to establish a sound argument in relation to the regulatory framework and license requirements in Sweden.

Question Number 1

Annalena Dierks:

I could only find a definition of banking business, which is defined as payment services via general payment systems and the receipt of funds after the notice is available to the creditor within 30 days.

In order to understand the different parts of the definition better I was wondering whether there are legal definitions of the following terms:

- payment services;*
- general payment systems;*
- receipt of funds.*

Emma Stuart-Beck:

Payment services are defined in Directive 2007/64/EC (the “**PSD**”) as:

- i) services enabling cash to be placed on a payment account as well as all the operations required for operating a payment account;
- ii) services enabling cash withdrawals from a payment account as well as all the operations required for operating a payment account;
- iii) execution of payment transactions, including transfers of funds on a payment account with the user's payment service provider or with another payment service provider:
 - execution of direct debits, including one-off direct debits;
 - execution of payment transactions through a payment card or a similar device; and
 - execution of credit transfers, including standing orders.
- iv) execution of payment transactions where the funds are covered by a credit line for a payment service user:
 - execution of direct debits, including one-off direct debits;
 - execution of payment transactions through a payment card or a similar device; and
 - execution of credit transfers, including standing orders.
- v) issuing and/or acquiring of payment instruments;
- vi) money remittance; and
- vii) execution of payment transactions where the consent of the payer to execute a payment transaction is given by means of any telecommunication, digital or IT device and the payment is made to the telecommunication, IT system or network operator, acting only as an intermediary between the payment service user and the supplier of the goods and services.

General payment systems are defined as systems for the forwarding of payments from a large number of payers who are not associated with each other, which are otherwise intended to reach a large number of ultimate payees who are not associated with each other.

Receipt of funds should be interpreted broadly and not considered only to encompass normal “deposits” (see further below). The key is that the funds received

must be made available to the creditor within thirty (30) days following termination. Consequently normal deposit taking, issuing of certain types of bonds and funds which are made available to the bank under other types of contracts should be considered receipt of funds pursuant to the BFA and the form or the name in which the funds are made available to the bank are not relevant.

Question number 2

Annalena Dierks:

Similarly I found a definition of financing business, which is defined as accepting repayable funds from the public and to grant loans, provide guarantees for loans or for financing purposes, or to grant rights of use in personal property (leasing). In order to understand the different parts of the definition better I was wondering whether there are legal definitions of the following terms:

- *repayable funds;*
- *public;*
- *grant loans.*

Emma Stuart-Beck:

In relation to financing business, repayable funds are defined as funds which are made available to the creditor within one (1) year following termination.

The term public is not defined in the BFA and should be interpreted very broadly. It is however possible to argue that financial institutions (e.g. banks, insurance companies and credit market companies) are not considered part of the public.

The BFA does not provide for an explicit definition for granting of loans. In practice this should however be interpreted to include all arrangements where a credit is given.

Question number 3

Annalena Dierks:

How are deposits defined under Swedish law? Is it essentially the same definition as for “accepting repayable funds from the public” or are they defined differently?

Emma Stuart-Beck:

A deposit (Sw. *insättning*) is defined in the Swedish Act on Deposit Guarantee (Sw. *lag (1995:1571) om insättningsgaranti*) as a balance which is in relation to a deposit. Even if ‘deposits’ in practice can be considered essentially the same as “accepting repayable funds from the public” it should be noted that the latter definition also covers additional arrangements.

Question number 4

Annalena Dierks:

Where do I find information in relation to the Swedish P2P license that has been introduced last year? From our call I remember that you said the license is not sufficient anymore. Did I understand it correctly that the Swedish regulator now thinks the P2P license can only be granted in combination with a payment institution license OR is the P2P license not relevant anymore?

Emma Stuart-Beck

The Swedish P2P license is regulated by the Swedish Act regarding Certain Operations with Consumer Credits (Sw. *lag (2014:275) om viss verksamhet med konsumentkrediter*) and the SFSA’s supplementary regulations and general guidelines FFFS 2014:8 on Certain Consumer Credit-related Operations. The regulations are available in English on the SFSA’s website. Further information can be found in the Act’s preparatory works (Sw. *Regeringens proposition 2013/14:107 – Viss kreditgivning till konsumenter*), which unfortunately only are available in Swedish.

The P2P license is still relevant. However, when mediation of credits is (or can be deemed to be) *combined* with either execution of payment transactions or money remittance (see the definition of payment services above) it would not be sufficient for an entity only to hold the P2P license.

B. Interview with Joris van Horzen, Associate Partner in the Banking & Finance Group at the law firm Kennedy Van der Laan

The initial contact was established via an Email introduction from a former colleague at Lendico. The interview was then conducted over the phone on February 1st, 2016. I prepared a list of questions to discuss with Mr. van Horzen. Please find the transcript below. The questions posed by Annalena Dierks are depicted in italics while the answers by Mr. van Horzen are depicted in normal writing.

Question number 1

Annalena Dierks:

When does a company qualify as a consumer credit provider that requires a license from the AFM under the WTF Act?

Joris van Horzen:

The license requirement according to 2:60 AFS /WTF Act regulates, that no party may grant credit in the Netherlands without a license granted for that purpose by the AFM.

Question number 2

Annalena Dierks:

What does “to grant” according to the AFS/WTF Act mean?

Joris van Horzen:

Two possibilities existed und Dutch law until last year:

Either a license if a platform wanted to grant credits or a license for intermediary services.

The first alternative included the granting of loans to consumers as well as the assigning of rights to investors.

The second alternative was a special light version of the license designed for platforms that just carried out intermediary services.

However the Dutch supervisory authority decided last year that the full consumer credit provider license is required for platforms that are involved in any kind of these activities.

Question number 3

Annalena Dierks:

Does the platform fall under any of the following definitions?

- *Financial service provider?*
- *Financial institution (-) as no activity according to PSD carried out*
- *Credit institution (-)*

Joris van Horzen:

Financial service provider: No the platform does not qualify as financial service provider.

Financial institution: No the platform does not qualify as financial institution, since no activity according to the PSD is carried out.

Credit institution: No the platform does not qualify as credit institution.

Question number 4

Annalena Dierks:

Which contracts do exist and when are the contracts concluded between:

- *The borrowers and the platform*
- *The investors and the platform*
- *The platform and the payment foundation?*

Joris van Horzen:

Borrower – platform

Between a borrower and the platform the following contracts are concluded:

- The Terms and Conditions are accepted by the borrower during the registration process;
- The Loan Agreement is concluded during the registration process under the conditions precedent that first, the platform receives all documents for the anti-money laundering (AML) check and second the loan is sufficiently funded and moneys are received from investors; and
- The borrower has to accept the Privacy Policy and included Standard EU Information during the registration process.

Investor – platform

The following contracts are concluded between an investor and the platform

- The Terms and Conditions as well as Privacy Policy are accepted by the investor during the registration process; and
- The Receivables Purchase Agreement, i.e. the Investment Agreement is concluded under the condition precedent, that the investment amount will only be debited from the investor if the Loan Agreement with the borrower becomes effective, i.e. the condition that sufficient investor moneys are committed is fulfilled.

Platform – payment foundation

The platform and the payment foundation enter a service agreement that allows the platform to receive moneys and hence transfer money through the payment foundation.

Question number 5

Annalena Dierks:

What is the role of the payment foundation, why is it needed in the legal setup of the operation of a peer-to-peer lending business?

Joris van Horzen:

Under the license, the platform has to comply with certain requirements. According to sec. 1:102 additional requirements apply for the platform, it sets forth a basic setup that applies to all platforms. One of the requirements is that the platform must use (through a service contract or establishment plus such contract) a payment foundation in order to receive and wire money. The rationale for that requirement being the protection of investor monies in case of bankruptcy, i.e. through the establishment of a separate entity which has the single purpose to hold and mediate investor moneys, the investor moneys are separated from the platforms' money and hence will not become part of the bankruptcy estate. Due to the service agreement, the platform is then allowed to receive and transfer monies.

Mr. van Horzen then explained some additional requirements under Dutch law as well as the current thinking of the Dutch regulator:

Joris van Horzen:

The platform furthermore has to comply with certain additional requirements in relation to investor protection:

- In the past, investors who are consumers, could not invest more than EUR 40,000. Recently this limit was raised to EUR 80,000.
- In order to inform the investor about the risks associated with the investment in consumer credits, they have to fill in some kind of survey, which is intended to ensure that investors are not only informed about the associated risks, but that they also understand them.
- The platform is furthermore required to inquire the investor's financial situation in order to assess whether the investor has the financial means for such an investment.

The Dutch financial supervisory authority currently has the position that the additional requirements for peer-to-peer lending will change over time together with the evolvement of the platforms themselves.

The AFM is supportive of peer-to-peer lending and hence does not want to impose too much and strict regulations on platforms, in order to not kill their business. Once the platforms and the whole peer-to-peer market has grown and evolved the AFM will introduce regulations that suit the requirements and business models of such businesses. Currently the AFM is still in the phase of closely monitoring the whole peer-to-peer business in order to assess the requirements, level of requirements and supervision that are needed.

More information on that can be found in the explanatory note from the AFM.